

# **FOREIGN TRADE POLICY REFORM IN CHINA**

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## Abstract

Along with its domestic economic transition, China has carried out a series of reforms in foreign trade and achieved significant policy changes. This thesis shows that China's export policies moved from strong government incentives to a state of market competition while import policies were switched from strict controls to significant liberalisation. In particular, the intensive trade policy reform in the 1990s demonstrated that China has been moving closer to trade liberalisation in line with most international trade practices.

Besides providing a comprehensive and updated account of China's trade policy reforms, this thesis contributes to understanding of the field by arguing that: (1) Unlike the trade policy reforms in some other countries, China seems to be a unique case due to its special economic and political conditions, its exclusive reform targets, its cautious reform approach, as well as its sensitive position in the world economy. (2) Econometric tests carried out in this study showed that China's trade policy reforms have been effective, although not all of them were optimal. China's move towards freer trade is thus shown to be the right choice for the economy and is consistent with the view that trade can positively promote growth. (3) China has followed a path of gradual reform with strong government intervention. Given the undeniable achievements and the special natures of trade policy reform, China's experience implies that the route to trade liberalisation can be varied and must be adapted to the specific conditions in the reforming country. (4) Trade liberalisation in China has been less conspicuous in terms of reform measures (for example, tariff reductions) made in the past reform period, due mainly to the incompleteness of the market economy. (5) The biggest challenge facing China is still how to combine trade liberalisation and government intervention, in order to establish a "socialist free trade system". Continuous emphasis on government control may contain the risk obstructing a sustained trade policy reform. China needs to adopt a "market-first" reform strategy to complete the establishment of a full-functioning market economy. The concept of "Chinese characteristics" can only be well-developed in market systems rather than in making use of the market forces on the basis of a government regulated economy.

The reforms in the past years have provided a foundation for China to go further towards trade liberalisation. China could, and should, move faster toward trade liberalisation.

# Contents

Abstract	
Contents	
Tables in Text	
Figures in Text	
Main Abbreviations	

<b>1 Introduction</b>	<b>1</b>
<b>1.1 China: A Fast Growing Economy</b>	<b>1</b>
1.1.1 Reform and Open-Door Policies	1
1.1.2 Growth of the Economy and Foreign Trade: Statistical Evidence	2
<b>1.2 The Framework of This Study</b>	<b>4</b>
1.2.1 The Theoretical Ground	4
<i>Free Trade and Trade Protection</i>	4
<i>The Variety of Trade Policy</i>	8
<i>Trade Policy Reform</i>	10
1.2.2 Focusing on China's Trade Policy Reform	15
<i>The Central Themes of China's Trade Policy Reform</i>	15
<i>The Significance of Theoretical Issues for China's Reform</i>	19
1.2.3 The Structure of the Thesis	20
<b>2 Institutional Reform in Foreign Trade</b>	<b>23</b>
<b>2.1 Devolution of Trading Rights</b>	<b>23</b>
2.1.1 Institutional Reorganisation	23
<i>Administrative Adjustments</i>	23
<i>Transforming Foreign Trade Enterprises</i>	25
2.1.2 Regional Strategy of Openness	26
<i>Special Economic Zones</i>	27
<i>Open Cities and "Economic and Technology Development Zones"</i>	28
<i>Coastal Area Development Strategy and the "Ladder-Style" Structure of Openness</i>	28
2.1.3 The Real Significance of Administrative Devolution	30
<i>Forming the Base for Freer Trade</i>	30
<i>The Limits of the Contract Responsibility System</i>	31
<i>Biased Decentralisation</i>	32
<b>2.2 Developing an Indirect Management System for Foreign Trade</b>	<b>33</b>
2.2.1 The Decline of Central Planning	33
2.2.2 The Emergence of the Market Mechanism	35
2.2.3 The Persistence of Government Intervention	37
<b>2.3 Assessing the Decentralisation in China's Trade Reform</b>	<b>40</b>
<b>3 Shifting Trade Strategy</b>	<b>44</b>
<b>3.1 Import Substitution Strategy in China</b>	<b>44</b>
3.1.1 The Adoption of an Import Substitution Strategy	44
3.1.2 Reconsidering Foreign Trade Strategy: Chinese Economists Debate	46
<i>Arguments</i>	46
<i>Right Choice for China: Coexisted or Integrated Trade Strategy?</i>	48
3.1.3 Trade Strategy Changes in China	51



<b>3.2 Effects of Import Substitution</b>	<b>52</b>
3.2.1 The Literature	52
3.2.2 Effects of China's Import Substitution	54
<i>Industrialisation and Import Substitution</i>	55
<i>Structure of Imports</i>	56
<i>"Compulsory Export"</i>	57
<i>Efficiency</i>	61
<b>3.3 Evaluating China's Experience of Trade Strategy Changes</b>	<b>62</b>
3.3.1 Classifying China's Trade Strategy	62
3.3.2 Evaluating China's Trade Strategy	66
<b>4 Formalising Export Policies</b>	<b>70</b>
<b>4.1 Subsidies and Prices</b>	<b>70</b>
4.1.1 Subsidies Related to Trade	70
4.1.2 Analysing the Effects of Subsidies	72
<i>Export Subsidies</i>	72
<i>Domestic Subsidies</i>	75
<b>4.2 Exchange Rate and Foreign-Exchange Retention</b>	<b>76</b>
4.2.1 Using Foreign Exchange Policies to Promote Exports	77
<i>The Foreign-Exchange Retention System</i>	77
<i>Exchange Rate System</i>	78
4.2.2 Impacts of Foreign Exchange Reform	80
<i>What is to Be Retained?</i>	80
<i>Getting the Exchange Rate Realistic</i>	81
<b>4.3 Duty Drawback System</b>	<b>82</b>
4.3.1 Duty Drawback and Export Promotion	82
<i>The Implementation of the Duty Drawback System</i>	83
<i>Duty Drawback Rates</i>	83
4.3.2 Issues Concerning the Duty Drawback System	85
<b>4.4 Other Export Incentives</b>	<b>87</b>
4.4.1 Export Financing	87
<i>The Size of Export Financing</i>	87
<i>The Motives and Effects of Export Financing</i>	88
4.4.2 Industrial Policies	89
4.4.3 Encouraging Exports from Foreign-Funded Enterprises	91
<b>4.5 Export Controls and Taxes</b>	<b>93</b>
4.5.1 Export Quota and Licensing System	93
4.5.2 Export Tax	96
<b>4.6 Evaluating China's Export Policy Reforms</b>	<b>97</b>
<b>5 Liberalising Import Policies</b>	<b>101</b>
<b>5.1 Tariffs</b>	<b>101</b>
5.1.1 The Use of Tariffs in the Chinese Economy	101
<i>Tariff and Trade Balance</i>	102
<i>Tariff Exemption</i>	103
5.1.2 Tariff Policy Reforms	104
<i>Tariff Reductions</i>	105
<i>The Elimination of Preferential Tariff Policies</i>	107
5.1.3 The Economic Analysis of China's Tariff Policies	108
<i>The Effects of High Tariffs</i>	108

<i>The Effects of Tariff Exemptions</i>	110
<i>The Effects of Tariff Reductions</i>	113
<b>5.2 Non-Tariff Measures</b>	116
5.2.1 Import Licensing and Quotas	116
<i>Using Import Licences and Quotas in China</i>	116
<i>The Significance of the Reforms in Licensing and Quotas System</i>	117
5.2.2 Foreign Exchange Control	119
<i>Exchange Rate</i>	119
<i>Access to Foreign Exchange</i>	121
5.2.3 Other Import Control Measures	122
<i>Import Planning and Trading Rights</i>	124
<i>Technological Standards</i>	126
<b>5.3 Evaluating China's Import Liberalisation</b>	127
5.3.1 Effective Rate of Protection	127
5.3.2 Remaining Problems of China's Import Liberalisation	128
 <b>6 Trade Policy Reform and Economic Development</b>	 <b>132</b>
<b>6.1 General Effects of Trade Policy Reform</b>	132
6.1.1 Trade Expansion and Openness of the Economy	132
6.1.2 The Improvement of Competitiveness	136
<i>The Change of Export Structure</i>	137
<i>China's Comparative Advantage</i>	138
<b>6.2 Trade Policy Reform and Trade Performance</b>	141
6.2.1 The Methodology and Data	141
<i>Cointegration Analysis</i>	141
<i>Implications and Data</i>	143
6.2.2 Results of the Cointegration Test	145
<b>6.3 Trade Policy Reform and Economic Growth</b>	151
6.3.1 Empirical Studies on Trade and Growth	151
6.3.2 Statistical Analysis on Exports and Growth: the Case of China	154
6.3.3 Approaches in Which Trade Works	157
<i>Efficiency of Resource Allocation</i>	158
<i>TFP Effect</i>	159
<b>6.4 Conclusion</b>	161
 <b>7 China's Trade Policy Reform in International Context</b>	 <b>164</b>
<b>7.1 China and the World Economy</b>	164
<b>7.2 China and the GATT/WTO</b>	167
7.2.1 China's Application to Rejoin GATT	167
7.2.2 The Political Economy of China's GATT/WTO Accession	168
<i>Something Benefiting All Sides</i>	169
<i>Arguments on China's Re-entry into GATT/WTO</i>	170
<b>7.3 China and the United States</b>	177
7.3.1 Bilateral Trade	177
7.3.2 The Role of the "US Factor" in China's Trade Reform	179
<i>"Negotiated" Trade Policy Reforms</i>	179
<i>How Important Is the "US Factor"?</i>	180
<b>7.4 China and the EU</b>	183
<b>7.5 China and East Asian Economies</b>	185
7.5.1 The Rapid Growth of China's Foreign Trade With East Asian Economies	186

7.5.2 The Special Significance of China-East Asia Trade	188
<b>8 Conclusion and Perspectives on China's Trade Policy Reform</b>	<b>193</b>
8.1 The Aggregate Evaluation of China's Trade Policy Reform	193
8.1.1 The Basic Characteristics of China's Trade Policy Reform	193
8.1.2 Assessing China's Experience of Trade Policy Reform	195
<i>Foreign Trade Strategy</i>	195
<i>The Domestic Economy and Foreign Trade</i>	197
<i>The Role of Government</i>	198
<i>Changes of Trade Policy</i>	200
8.2 The Challenge Facing China	201
8.2.1 Free Trade versus Chinese Characteristics	202
8.2.2 The Connecting Point	204
<b>Appendix</b>	<b>209</b>
<b>Bibliography</b>	<b>211</b>

## Tables in Text

Table 1.1 China's GDP and Foreign Trade (1978-1997)	3
Table 3.1 Share of Imports in Total Supplies (SITS)	55
Table 3.2-a China's Import Structure in Pre-reform Period, Selected Years	56
Table 3.2-b China's Import Structure (1980-1996)	56
Table 3.3 Terms of Trade, 1973-95 (1987=100)	58
Table 3.4 Efficiency of State-Owned Industrial Enterprises	61
Table 4.1 Government Subsidies (1985-1996)	70
Table 4.2 Price Indices, Selected Years	73
Table 4.3 Losses of FTCs and Government Subsidies to SOEs	74
Table 4.4 Export Tax Rebates	83
Table 4.5 Share of Foreign-Funded Enterprises' Export in China's Total Exports	92
Table 4.6 Commodities Subject to Export Quota Licensing (1993)	94
Table 5.1 Changes of China's Average Nominal Tariff Rate	107
Table 5.2 Sectoral Ratio of Dependency on Imports (1990-1992)	111
Table 5.3 Share of Processing Trade in China's Foreign Trade (1991-1995)	112
Table 5.4 Imports of Some Tariff-reduced Commodities	114
Table 5.5 Number of Imports (commodity group) Subject to Licensing (1980-1996)	116
Table 5.6 Import Controls, July 1995 (quotas, licences and automatic registration)	117
Table 6.1 China's Ratio of Foreign Trade to GDP	134
Table 6.2 The Real Degree of China's Openness on Trade	136
Table 6.3 Exports of Textile, Mechanical and Electrical Products	137
Table 6.4 Indices of China's RCA and Trade Performance (1990, 1995)	139
Table 6.5 Unit Root Tests for Variables of Trade and Exchange Rate	146
Table 6.6 Cointegrating Regressions	147
Table 6.7 The Error Correction Models Based on Cointegrating Regressions	149
Table 6.8 Testing the ECMs Using the Dummy Variables	150
Table 6.9 Unit Root Tests for Variables of GDP and Exports	154
Table 6.10 Cointegrating Regression and The Error Correction Model	155
Table 6.11 Average Annual Growth Rates of GDP and TFP	160
Table 6.12 Sources of China's Economic Growth	160
Table 7.1 Average Annual Growth Rate of Exports	164
Table 7.2 China's Share in World Total Exports	164
Table 7.3 Discrepancies in China's Trade Policy Reform (up to 1997)	175
Table 7.4 China-US Bilateral Trade Statistics	177
Table 7.5 China's Trade with the EU	183

## **Figures in Text**

Figure 4.1 Official Exchange Rates and REERs (index 1978=100)	81
Figure 5.1 Trade Balance (1978-1997)	102
Figure 5.2 Collected Tariffs as Percentage of Imports (1978-1996)	104
Figure 5.3 Imports and Exports of TV Sets (1980-1996)	107
Figure 6.1 Growth Rates of GDP, Exports and Imports (1979-1997)	133
Figure 7.1 China's Trade with Ten Major East Asian Economies (1980-1996)	187

## Main Abbreviations

AER	applied exchange rate
APEC	Asian-Pacific Economic Co-operation
CPI	consumer price index
DIP	<i>de facto</i> import promotion
EBRD	European Bank for Reconstruction and Development
EER	effective exchange rate
EP	export promotion
ERP	effective rates of protection
ESCAP	Economic and Social Commission for Asia and the Pacific (UN)
ETDZs	economic and technological development zones
EU	European Union
FDI	foreign direct investment
FEACs	foreign exchange adjustment centres
FER	foreign exchange retention
FFE	foreign-funded enterprises
FTCs	foreign trade corporations
GATT	General Agreement on Tariff and Trade
GDP	gross domestic product
GNP	gross national product
GSP	general system of preferences (or General Scheme of Preferences)
HNTDZs	high and new technological development zones
HS	Harmonised System
IMF	International Monetary Fund
IPR	intellectual property rights
IS (ISI)	import substitution (industrialisation)
MFN	most favoured nation treatment
MOFERT	Ministry of Foreign Economic Relations and Trade (China)
MOFT	Ministry of Foreign Trade (China)
MOFTEC	Ministry of Foreign Trade and Economic Co-operation (China)
NBER	National Bureau of Economic Research (US)
NIEs (NICs)	newly industrialised economies (countries)
NTBs (NTMs)	non-tariff barriers (measures)
OECD	Organisation for Economic Co-operation and Development
PEP	protected export promotion
PPP	purchasing-power-parity
REP	relative export performance
REER	real effective exchange rate
SEZs	special economic zones
SOEs	state-owned economies (enterprises)
TFP	total factor productivity
TVEs	town and village economies (enterprises)
UNCTAD	United Nations Conference on Trade and Development
USTR	United States Trade Representative
WTO	World Trade Organisation

# **1 Introduction**

## **1.1 CHINA: A FAST GROWING ECONOMY**

Over the past two decades, China has experienced dramatic changes in its economic regime and has achieved rapid growth. China's transformation from a virtually closed economy to a major trading nation has attracted wide attention. Many studies of China's economic reform have suggested that China's rapid growth was derived from its sustained domestic reforms and the opening up of the economy to the rest of the world.

### **1.1.1 Reform and Open-Door Policies**

As early as 1978, the Bulletin of the Third Plenum of the 11th Communist Party Central Committee pointed out that it was necessary to introduce the law of value into China's economic system, in order to improve economic performance. Subsequently, many reform measures — from small to large scale and from simple to complex — were carried out in the process of economic transition. Among these reform measures, the most important ingredient was the development of market systems. At the 14th Communist Party Congress held in October 1992, China finally set its economic reform target as the building up a socialist market economy. Through the sustained reform over the past two decades, the market mechanism has been playing an increasingly important role in the deployment of resources and other economic activities.

Along with the domestic reforms, opening up the economy to the outside world has also been an important factor in China's rapid growth. The opening-up of the economy itself is an important part of reforms which mark the transition of the centrally-planned economy to an open market economy. The basic components of China's open policy are openness in trade, foreign investment and foreign technology. Of these, the crucial element is trade reform, or trade liberalisation. The other aspects of openness are all, to some degree, related to the area of foreign trade.

China's open-door policy has led to significant changes in the foreign trade regime. Reforms in trade, foreign investment and other foreign transactions have produced a more open economy in China. The ratio of foreign trade to GDP increased from 9.79% in 1978 to a peak of 43.72% in 1994. This suggests that the development of the Chinese economy is increasingly linked to the world market.<sup>[1]</sup> As the world economy is a market-based system, the Chinese economy has become increasingly reliant on market forces. International norms have been successfully introduced into the Chinese economy. It also suggests that the effects of the open-door policy have led to the desire for more reforms in the foreign trade sector. China has set up its trade reform target in the establishment of a "socialist free trade system". More importantly, China has carried out a series of intensive policy reforms since the early 1990s, signalling a stronger trend towards trade liberalisation.

### **1.1.2 Growth of the Economy and Foreign Trade: Statistical Evidence**

Reform and opening up policy have generated a positive result in economic growth for China. Table 1.1 provides an illustration of the rapid growth of China's economy and foreign trade in the reform period. China's gross domestic production (GDP) was 7,477.20 billion *Renminbi Yuan* (hereafter *Yuan*) in 1997, 8.8% (in constant prices) up from that of the preceding year (*China's Scholars Abroad* 9/1/1998). The annual average growth rate of GDP in real terms during 1979-1997 was 9.9%, 3.5 percentage points higher than that of 1953-1978. This growth rate was much higher than the world average growth rate (3.0%) and also higher than that of Asian countries such as Korea (8.3%), Singapore (7.6%), Malaysia (7.4%), Thailand (7.4%), Indonesia (6.0%) and India (4.9%) in approximately the same period (1979-1994). China's per capita GNP in 1995 was 4,754 *Yuan*, 2.88 times (in constant prices) higher than that of 1978. The annual average growth rate of per capita GNP during 1979-1994 was 8.3%. In constant 1987 prices, the share of China's GDP in the total GDP for the world increased from 2.3% in 1990 to 3.2% in 1994 (Zhang Sai 1995; State Statistical Bureau 1996b, 1997b; *China's Scholars Abroad* 9/1/1998).

One of the basic reasons behind the rapid growth of GDP has been the dramatic opening of the country to foreign trade and investment. The opening-up of the economy led to positive policies encouraging the development of foreign trade, in keeping with increasing international interdependence. Since reform, China's foreign trade has expanded rapidly. The goal of foreign trade growth set in 1982 was that the total value of imports and exports



should be doubled twice (reaching about US\$160 billion) by the end of the 20th century (Chen Muhua 1982). In fact, this target was achieved in 1993 (US\$195.70 billion). In 1993, a new target was presented to take China into the top ten foreign trading nations in the world (*China's Foreign Trade*, No. 10, 1993, p. 3).

**Table 1.1 China's GDP and Foreign Trade (1978-1997)**

Year	GDP (billions of Yuan; %)				Foreign Trade (US\$ billion; %)						
	GDP	Growth rate	GDP90*	Growth rate	Total Trade	Growth rate	Exports	Growth rate	Imports	Growth rate	Trade Balance
1978	362.41		649.0		20.64		9.75		10.89		-1.18
1979	399.81	10.32	698.4	7.61	29.33	42.10	13.66	36.76	15.67	40.34	-2.01
1980	451.78	13.00	752.9	7.67	38.14	30.04	18.12	32.94	20.02	27.66	-1.84
1981	477.51	5.70	786.6	4.48	44.03	15.44	22.01	19.12	22.02	8.18	-0.01
1982	518.23	8.53	851.5	8.25	41.61	-5.50	22.32	1.56	19.29	-12.36	2.99
1983	578.70	11.67	940.5	10.39	43.62	4.83	22.23	1.37	21.39	12.90	0.85
1984	717.10	23.92	1077.4	14.57	53.55	22.76	26.14	12.56	27.41	24.07	-1.50
1985	896.44	25.01	1216.3	12.91	69.60	29.97	27.35	10.30	42.25	61.98	-15.34
1986	1020.22	13.81	1319.5	8.48	73.85	6.11	30.94	14.12	42.91	1.20	-11.96
1987	1196.25	17.25	1466.2	11.12	82.65	11.92	39.44	25.74	43.21	-0.01	-3.85
1988	1492.83	24.79	1631.1	11.25	102.79	24.37	47.52	20.23	55.27	27.39	-7.74
1989	1690.92	13.27	1701.8	4.33	111.68	8.65	52.54	9.08	59.14	5.71	-6.58
1990	1854.79	9.69	1854.8	8.99	115.44	3.37	62.09	18.15	53.35	-10.12	8.75
1991	2161.78	16.55	2025.3	9.19	135.63	17.49	71.84	14.99	63.79	19.03	7.88
1992	2663.81	23.22	2313.7	14.24	165.53	22.05	84.94	14.28	80.59	22.04	4.16
1993	3463.44	30.02	2625.8	13.49	195.70	18.23	91.74	12.98	103.96	35.01	-12.12
1994	4662.23	34.61	2958.3	12.66	236.62	20.91	121.01	31.71	115.61	11.13	5.25
1995	5826.05	24.96	3270.4	10.55	280.85	18.69	148.77	24.17	132.08	15.29	16.69
1996	6779.50	16.37	3587.6**	9.70	289.90	3.22	151.07	1.55	138.83	5.11	12.24
1997	7477.20	10.29	3904.3**	8.80	325.06	12.10	182.70	20.90	142.36	2.50	40.34

\*: GDP90 denotes GDP in constant 1990 prices.

\*\* : Calculated according to published annual growth rates based on comparable prices.

Source: State Statistical Bureau (1996b, 1997b); IMF (1997); *Wen Wei Po* 12/1/1998.

Both exports and imports expanded at a rapid pace. Exports in 1997 of US\$182.70 billion were equal to 18.74 times the exports of US\$9.75 billion in 1978; while imports of US\$142.36 billion were 13.07 times the imports of US\$10.89 billion in 1978. The value of total trade (exports plus imports) increased from US\$20.64 billion in 1978 to US\$325.06 billion in 1997. The annual average growth rate of foreign trade between 1979-1997 was 15.61%, higher than that of GDP in real terms (9.9% in constant 1990 prices) in the same period. The average annual growth rates of exports and imports during this period were in the top range in the world. Related to the expansion of foreign trade, during the reform period, has been the introduction of a large amount of foreign capital into China's economy. The actual used foreign investment in China during 1979-1997 reached US\$346.405 billion (State Statistical Bureau 1997b; *China's Scholars Abroad* 9/1/1998).

Changes in China's trade regime and policies and the rapid growth of foreign trade in the past reform period have been impressive. Many people regard China's trade reform as a success story. However, the fact that China has not been admitted as a member of the GATT/WTO,<sup>[2]</sup> after more than ten years of effort, has forced researchers to rethink China's trade reform. China's failure to enter the GATT/WTO suggests that reforms of the trade regime and policies in China have not satisfied the conditions of free trade, despite the fact that China's economy has become much more open than it was. The question raised here is to what extent has China's trade reform been successful? An appropriate assessment should be based on an analysis of China's experience of foreign trade reform.

This study is an attempt to examine the process of China's trade reform, and to evaluate the role of trade policy reform in the rapid development of the Chinese economy. Special emphasis is given to trade policy changes and their impact on China's economy.

## **1.2 THE FRAMEWORK OF THIS STUDY**

### **1.2.1 The Theoretical Ground**

#### ***Free Trade and Trade Protection***

In classical economics, foreign trade was considered important for economic growth. Adam Smith once explained that international trade is the principal means by which a country could extend the market beyond its territory. The development of foreign trade allows countries to realise greater specialisation in production, enhanced efficiency in the use of resources, and greater welfare. Through liberal transactions between countries (on the same basis as these within a country) a rational trade-induced division of labour becomes the main underlying condition for economic growth. David Ricardo introduced the concept of comparative advantage into the theory of international division of labour and showed that specialisation between countries based on comparative advantages may benefit all participants of international trade. According to the theory, different countries have their comparative advantage in different commodities. That is, a country produces a given commodity at lower *opportunity cost* than another country.<sup>[3]</sup> Free trade permits countries to specialise in different commodities according to their comparative advantage and allows each country to consume at least as much of each good as before specialisation. Moreover, free trade minimises the real cost of obtaining a given income or quantum of consumption for the world as a whole. The implication of Ricardo's theory is that international trade

becomes an effective tool for achieving economic efficiency (Gomes 1987, p. 139). The domestic economy of international trade participants can be benefited from mutual trade.

Neo-classical economics took over the classical view in regard of the linkages between trade and growth. Neo-classical trade theory regards specialisation according to comparative advantage yields gains from trade that increase the resources available for investment. Alfred Marshall, the first neo-classical economist, pointed out that “the causes which determine the economic progress of nations belong to the study of international trade” (Quoted by Ronald Findlay, see Findlay 1985). According to Marshall’s theory, foreign competition through trade (1) increases the efficiency of domestic industry; (2) provides opportunities for the migration of capital and labour; (3) exerts an influence on the steadiness of employment; and (4) assists in the development of large-scale industry (See Gomes 1990, p. 42). Bertil Ohlin, an important trade economist, identified the source of comparative advantage as lying in the nature of each country’s factor endowment. Free trade policy may lead to the best use of a country’s factor endowments. Each country has a comparative advantage in the products that use intensively the factor(s) in relative abundance in the country. Furthermore, international trade may have powerful indirect effects, exposing people to new ideas and technology which will shift out the production possibility frontier (Pomfret 1991, p. 198). Liberal trade policy will increase both domestic welfare and global welfare by permitting a fuller international division of labour according to comparative advantage.

Clearly, the neo-classical economics tradition regards market liberalisation and moves towards freer trade as crucial to improvement in the efficient allocation of resources. Haberler (1959) gives a synthetic expression of neo-classical theory on the contribution of trade to development:

“First, trade provides material means (capital goods, machinery and raw and semi-finished materials) indispensable for economic development. Secondly, even more important, trade is the means and vehicle for the dissemination of technological knowledge, the transmission of ideas, for the importation of know-how, skills, managerial talents and entrepreneurship. Thirdly, trade is also the vehicle for the international movement of capital especially from the developed to the undeveloped countries. Fourthly, free international trade is the best antimonopoly policy and the best guarantee for the maintenance of a healthy degree of free competition.” (Haberler 1959, reprinted in Theberge 1968, pp. 108-109)

It is also worth noting that, in the course of the development of the neo-classical economics, some places have been left for the interventionist/protectionist views.<sup>[4]</sup> This distinguishes the neo-classical concept of free trade from *laissez-faire* regime (which is the real meaning of free trade in classical economics). But in the whole, neo-classical theory is understood as one which is based on the idea that prices clear markets. Interventions are only allowed as in a minimal mode to correct market distortions, for an efficient allocation of resources and the realisation of comparative advantage.

Distinguished from the traditional neo-classical theory, a set of thinking on trade and development so-called “neo-liberalism” has grown up and become influential since the 1980s. The neo-liberalism also persists in the principle of comparative advantage, but argues further that imperfect markets are better than imperfect states in resource allocation. Anne Krueger (1997, 1995), who is classified as one of the five leading authors of the neo-liberalism,<sup>[5]</sup> criticises the phenomenon that the economics profession with consensus on principle of comparative advantage misuses the good theory and embraces a highly protectionist policy stance. With an assessment based on the East Asian experience that developing countries could develop rapidly and would not be necessary to be specialised in production of primary commodities, Krueger calls for a deeper integration between developing countries and the international economy. Holding the principle of comparative advantage, adopting outward-oriented trade strategy and liberalising trade policies are considered crucial for industrialisation and economic development in developing countries.

A new growth theory developed in recent years stresses the role of openness in trade and export externalities as positive factors in promoting long run growth. This theory holds that trade may play an important role in the diffusion of modern technology and know-how across countries. With international spillovers of knowledge and technology, a country may obtain new technology from its counterparts to develop its own potential of comparative advantage (Grossman and Helpman 1990). The pattern of international specialisation will also be dynamically changed in accord with newly formed comparative advantages in nations. By “learning by doing”,<sup>[6]</sup> a newly open country may opt for the industry with high growth potential and experience more rapid economic growth. This is because that the effect of learning by doing (imitation) could lower the cost of development for late comers and knowledge spillovers from advanced countries become a source for speeding up economic

growth. On the other hand, imitation by the late comers also has reinforcing effects on industrial countries to develop new technology for keeping up their leading positions.

Beside the theories for free trade, there are also arguments backing the requirement of trade protection. The oldest and most popular issue of trade protection is the infant industry argument. The essence of the argument is: There are some industries which are initially not competitive in the world markets but having a comparative advantage in the long term. Such industries in their early stages (i.e., as infant industries) require temporary protection by government intervention against their well-developed foreign competitors. Protection can be removed once the infant industries have grown up and become able to withstand foreign competition.

Structuralism was one of the most influential post-war trends of thought on development, especially in the developing world. A key frame of the structuralist view is that the world has become a “centre-periphery” dichotomy. The mature industrialised economies at the “centre” specialised in manufactures and benefited from scale economies. The developing countries at the “periphery” specialised in producing low-productivity primary products. These essential differences of economic structure ensure that the gains from trade are steered towards the “centre”, and the “periphery” has to be in a dependency status in the world economy. Structuralists consider that the unfavourable structure of the international economy caused market failure or market imperfection. In developing foreign trade, developing countries have to face problems such as terms of trade decline, export instability, pervasive infant industries and a maldistribution of the gains from trade. Very naturally interventionist trade policy, which tends to inward-orientation, has been adopted by developing countries to avoid such unfavourable impacts of the external economy. In practice, the import substitution sectors have been promoted by protection in forms of high tariffs, strict import quotas and over-valued exchange rates.

More recently, a so-called “strategic trade theory” (or “new trade theory”) concerns imperfect competition in international trade and the corresponding government policies. On the whole, this theory may not be regarded a protectionism theory. But there is something to be noted. This theory is based on two major assumptions. One is that markets are both oligopolistic and segmented. Firms are able to affect or change prices in different markets

and obtain superprofits or monopolistic profits. The other is the existence of economies of scale. Trade development (especially the export externality) brings an opportunity to reach the effect of increasing return to scale that causes real economic growth. A crucial concept of the strategic trade theory is “profit-shifting”. Aggressive government policies aiming at economies of scale and export expansion, such as export subsidies, tariffs, and other industrial policies, may shift profits from a foreign firm to its domestic competitor. The domestic firm may benefit from the effect of increasing return to scale. Although this theory is built upon the special phenomenon of oligopolistic competition and rarely matched the cases of developing countries, the idea for the strategic use of government policy is likely to be a new root of government intervention.

### ***The Variety of Trade Policy***

Trade policy had been regarded as a matter of domestic concern. Although the principles of comparative advantage and free trade have been widely accepted, there were still some questions frequently raised concerning the required underlying conditions which would determine attitude towards free trade. Different views on the role of foreign trade in economic development prompted economists to explore their policy implications from these different approaches. In the absence of a generalised long-term trade policy applicable at all times and in all contexts, international trade theories and their associated trade policies have historically been classified broadly into free trade and trade protection schools.

However, the development of trade policy has been more complicated than what have been identified in theories. It is important to make a distinction between *prescriptive policies* and *actual policies*. The former are normative policy recommendations which come from the arguments of economists on the basis of normative trade theory, while the latter are the outcome of policy-making based on the weight of economic and non-economic factors. Prescriptive trade policies may be “first-best”, sometimes optimal, given that these policies stress the welfare maximisation at both national and international levels. Actual trade policies, as affected by political factors, diverge from the “first-best” trade policies. The long-lasting controversy between free trade and trade protection has been reflected in the differences between prescriptive and actual trade policies.

Before World War I, mainstream economics appreciated the contribution of international trade. It was thought that the imposition of tariffs would disturb the optimal allocation of resources and lower the potential benefits the countries could obtain. In contrast, by enlarging markets beyond national territories, free trade could increase the welfare of individual countries and the world economy as a whole. As classical economics dominated within the major economies, a free trade system was considered to be the ideal situation and was therefore the principle behind trade policy making. In practice, most advanced capitalist countries, such as Britain and France at the time, made great efforts to develop foreign trade as one of the main sources of investment and economic development.

Although protectionist arguments had some influence on trade policy choice over time, free trade theory and policy had not met any strong challenges until World War I, or rather as late as the 1930s. The 1929-1933 Great Depression restarted protectionist policy and led to a series of discretionary and uncoordinated trade policy changes. In the 1930s, the trade policies of the major economies featured high tariff protection. Before World War II, protectionist policy developed to a new peak and was accompanied by various trade wars (involving tariffs, quotas, and import regulations) between countries.

Soon after World War II, with the rapid recovery of the world economy from the damage of the war, economic expansion stimulated by trade development led to a free, open and more stable world trade system. Consequently there was a call for liberalisation of the international trade regime. The signing of GATT in 1947 ensured that the effort became international. The aims of GATT were to provide a set of rules to govern trade between the contracting parties, and promote reductions in trade barriers. The main economies in the world, at the time, took part in this movement towards trade liberalisation and the number of participants increased significantly over succeeding decades. Since the establishment of the GATT, great progress has been made in reducing tariffs on industrial goods. Since the Tokyo Round negotiations (1973-1979), increasing attempts have been made to reduce non-tariff trade barriers. In the Uruguay Round (1986-1994), the range of negotiations was greatly extended. Through the multilateral negotiations held under GATT, a greater degree of trade liberalisation has been achieved. The world trading system has become freer and now plays an important role in linking the economies in the world.

In the 1950s and 1960s, while developed countries were devoted to trade liberalisation, the import substitution (IS) strategy, that usually featured numerous protection measures, was widely adopted in the developing world. However, beginning in the late 1960s and early 1970s, this inward-looking trade policy gradually “faded out”. A number of developing countries switched over to more outward-looking, export promotion (EP) policies. From this shift, in the 1980s, emerged a new round in the liberalisation effort. Trade policy reform, either as the result of economic adjustment or as the crucial means for launching a new development drive, spread rapidly throughout the developing world.

By and large, free trade policy increasingly has been the main trend in the post-war period. However, the road to trade liberalisation has not been without setbacks. Ironically, in the late-1970s, developed countries started extending, reintroducing and creating non-tariff barriers to trade, and this trend continued into the 1980s (Page 1993). Protectionist pressures once again influenced trade policy-making in all countries. The WTO reported that, in the early and mid-1980s, high tariffs were widespread in developing countries and non-tariff barriers were common in both developed and developing countries (WTO 1996). In developed countries, while tariffs remained low, non-tariff barriers increased significantly. Developed countries’ imports affected by non-tariff barriers rose from 25.3% in 1966 to 48.0% in 1986, almost doubling in the twenty years (Laird and Yeats 1990).

The successful conclusion of the Uruguay Round, in which participants committed themselves to continued trade liberalisation, has weakened the momentum of the new protectionism. Agreed tariff reductions,<sup>[7]</sup> elimination of non-tariff measures and the extension of liberalisation to services and other trade-related areas have brought some optimism towards trade liberalisation. The establishment of the Trade Policy Review Mechanism has greatly increased transparency in the trade policies and practices of the WTO members. This shows that the international community is still confident in establishing a freer world trade system based on market rules which promotes growth in line with comparative advantage.

### ***Trade Policy Reform***

The variety of trade policy accommodated the discrepancies in theories. It is an interest to note the evolution of thought about trade policy. Corden (1974, 1997) identified three



stages of thought: free trade as an extension of *laissez-faire*, trade intervention as the second-best for the case of free trade, and trade instrument as the one of the all distortion-correcting policy instruments.<sup>[8]</sup> In the sense of the above three-stage classification, the evolution of economic thought about trade policy can be understood as the follows.

In the first stage, the classical tradition of liberalism dominated economics thought. Free trade was considered a special case of *laissez-faire*. Under certain circumstance, free flows of commodities and perfect functioning of the markets may lead to an optimum with maximum welfare for trading parties. Any trade intervention is therefore unnecessary.

The second stage of thought came to the recognition that the presumption for a perfect competition in favour of *laissez-faire* cannot be met. The arguments for intervention in trade emerged as that some market failures make free trade inappropriate. On the other hand, for the case for free or freer trade, a “theory of the second best”<sup>[9]</sup> had been developed, in support to pursuing a constrained optimum — a second-best optimum under insufficient conditions for Pareto optimality.

In the third stage of thought, important developments have been seen in several aspects. First, “the link between the case for free trade and the case for *laissez-faire* was broken” (Corden 1997, p. 3). There is a recognition that some policy intervention may be in need to correct distortions. Therefore, in a distorted world, there is no presumption that *laissez-faire* is optimal. Second, there is also no presumption that trade intervention is appropriate (Corden 1997; Brenton *et al.* 1997). Many distortions to be corrected are caused by “domestic” factors rather than by trade itself. The first-best instrument that focuses more directly upon the distortion should be used instead of trade policy, because trade policy is too remote from the distortion. It is not necessary to emphasise the use of trade policy because policy instruments themselves also create distortions. In this sense, free trade is optimal. Third, in some circumstance when the direct instruments are not used, or cannot be used, trade intervention may still be better than nothing (Corden 1997, p. 3). This means that trade policy is still one of a wide range of policy instruments for distortion correction. However, in using trade policy, it is important to ensure the effect to be beneficial. The choice between different policies should follow a principle that the costs of using the instrument will not outweigh the benefits.

Over the recent decades, there are numerous studies on the use of trade policy. Most importantly, given the relevance of this study, the following aspects need to be noted. First, the “theory of domestic distortion” established the principle that most distortion result from domestic factors rather than from external trade. Trade policy is therefore not the best instrument of dealing with the distortion (Johnson 1965; Bhagwati 1969; Corden 1974, 1997). Excessive use of trade instrument could have less effect than the direct means to the objective. In addition, trade policy may also create distortion. The significance of the theory of domestic distortion is that it restores the argument for free or freer trade. Second, besides domestic distortion, there are also trade distortions, especially in a highly protected trade regime. Trade distortions are usually reflected in the costs of protection. Many studies have shown effective analyses on this topic, covering a wide range of trade policies including tariffs, quotas, exchange rate and other non-tariff measures.<sup>[10]</sup> Third, a number of analytic tools, such as “revealed comparative advantage” index, “trade regime bias” ratio, “effective protection rate”, measurement of openness, econometric models, and so on, have been developed to measure the effects of trade policy. This enabled researchers to examine trade policy in a deeper level and estimate the impacts of trade policies accurately.

With the progress in the recognition of the role of trade policy, changes in trade policy became highly demanded in all countries, especially in the developing world. As trade liberalisation remains the main trend in the world of trade, developing countries which have previously adopted trade protection are faced with the task of reforming their trade policies in order to pursue outward-oriented development or obtain stronger incentives for domestic growth through trade expansion. The significance of trade policy reform is explicable in the following two expectations. First, in a distorted circumstance, trade policy reform intends to reduce the excessive use of trade instruments, leaving the distortions to be tackled with direct counter-measures. The reduction of trade intervention would enabled that trade flow freely, benefiting trade parties with improvement of resource utilisation. Second, with regard to “market failures”, trade policy plays the role as one of the instruments serving the target of market completion. On the whole, the most important task of trade policy reform is to restore the constrained natures of market mechanism which has been proven the most powerful means to efficiency, and then growth.

The concept of trade policy reform in economic literature is very close to “trade liberalisation”. Or, at least, trade policy reform is regarded as the most important ingredient of trade liberalisation. As Thomas *et al.* (1991, p. 10) indicated, “most objections to trade policy reform concern measures that are generally encompassed by the term liberalisation”.

But what is trade liberalisation? Economists presented various definitions. Dean *et al.* (1994) classified the main definitions of trade liberalisation into four categories. The first considers that trade liberalisation should lead to more reliance on the price mechanism, and a reduction in the anti-export bias of the trade regime. The second concerns the policy action that reduces the restriction of controls. The third emphasises neutrality as the central aspect of liberalisation. The fourth is an aggregate definition that includes the ingredients of neutrality and liberality. In addition, the fourth may be a phased liberalisation. This regards trade liberalisation as going through the phases of “mild liberalisation” (increased reliance on the price mechanism and reduced anti-export bias), “intensive liberalisation” (moving to neutrality), and “drastic form of liberalisation” (increased liberality).

Edwards (1989a), after a systematic survey of the definitions of this concept, pointed out that the definition close to that of the original Krueger-Bhagwati NBER project would be “the most useful one”:

“Trade liberalisation is a process that makes greater use of the price system, making the trade regime more transparent and bringing domestic prices closer to world prices.” (Edwards 1989a)

This definition emphasises the dominance of market price mechanisms in the trade process. It also contains the requirements of neutrality. With the reduction of anti-export bias, and particularly the removal of quantitative restrictions, trade liberalisation would lead to a more neutral and transparent regime. As a “process”, trade liberalisation could also be carried out in a phased manner.

Based on the spirit of trade liberalisation, Thomas and Nash (1992) gave their definition of “trade policy reform” as follows:

“It covers measures that move the trade regime toward a more neutral incentive framework for foreign trade, toward a more liberal trade regime, or toward both. Neutrality refers to incentives among and between exportables and importables, between sales to domestic and export markets, and between tradables and non-tradables. A more liberal trade

regime refers to the reduction of controls and to the replacement of direct interventions by price mechanism.” (Thomas and Nash 1992)

In light of the above definitions, a general understanding of trade liberalisation which is used here involves three main aspects. They are the increase of trade regime transparency, the reductions of import barriers and the normalisation of export incentives. The latter two are the core of trade policy reform, while the first may be regarded as the precondition or environmental support to trade policy reforms. In this study, trade policy reform is broadly defined as reshaping the existing policy measures in order to create a favourable environment for trade expansion. Specifically, trade policy reform refers to the significant changes in policy measures towards a neutral or freer trade policy system. Obviously, trade policy reform is only a part of trade liberalisation.

Trade policy reform involves a large number of policy changes. Thomas *et al.* (1991) classified the main reform measures into three categories: export policy reform, import policy reform and the correction of trade regime bias. They found that great attention has been paid to the reduction of quantitative restrictions whilst moderate effort has been given to tariff adjustments (pp. 27-29). Dean *et al.* (1994) examined the following four aspects of trade policy reforms: import tariffs, quantitative restrictions on imports, export impediments and incentives, and the degree of exchange rate misalignment (p. 11). Other similar studies (e.g. Papageorgiou *et al.* 1991) also showed the same components of liberalisation (trade policy reform). Institutional reforms and reforms in some trade-related areas including administrative management, legal systems, foreign investment policy, and even the foreign exchange rate system are important parts of trade liberalisation but do not constitute the “pure” components of trade policy reform.

Although, in most cases, export policies need to be reformed, import liberalisation has become the focus of trade policy reform on all sides, whether members of the reform movement or not. There are two reasons behind such an emphasis. Import liberalisation is all the more important in order to bring about competition, to promote exports, and to help control inflation, since creating workable domestic competition will take time in developing small and medium-sized economies (Koves and Marer 1991). Another fact is that import barriers in developing countries are higher than in the developed world. For greater compatibility with the world economy, import liberalisation, as a cost for expanding external markets, becomes the core ingredient of trade policy reform.

### **1.2.2 Focusing on China's Trade Policy Reform**

#### ***The Central Themes of China's Trade Policy Reform***

Before reform, China's foreign trade featured "state trade" or "over-centralisation". Foreign trade, functioning mainly as a channel through which China exported goods to pay for the import of equipment and other production materials, was considered simply a means of meeting the balance of materials required for domestic economic development. Due to the dominance of central planning, trade policy had no place in the regulation of trade flows. The planning authority assumed the responsibility for sorting out the items and quantities of goods that had to be imported. The total amount of trade, the prices of the import and export products, the variety and the specification of the trading goods, and even the exchange channel, were assigned by the state through the annual foreign trade plans. The foreign trade corporations (FTCs), under the state's supervision, were responsible for implementing the state's foreign trade plans.

China began its trade reform when it adopted an open-door policy at the end of the 1970s. Starting with the devolution of trading power, which implied the reduction of direct centrally-planning controls, trade policies became increasingly powerful instruments for adjusting foreign trade activities. Twenty years on, China has experienced significant trade policy change, including introducing trade policy instruments, formalising export incentives and liberalising import restrictions.

China's trade policy reform can be roughly divided into two major phases. The first phase was the late-1970s and 1980s, China concentrated on decentralisation (administrative devolution). With the progress of reform and the gradual understanding on market forces, some trade policies (mainly relative to export incentives) were reformed. But these reforms were mainly administrative adjustments rather than market reforms. The second phase is the period since 1991 during which China has carried out its intensive trade policy reform based on market reform, and reform emphasis turned towards reducing import barriers. China has eventually incorporated all aspects of trade policy reform. The significance of the full-ranged trade policy reform is that China has moved into the right track for trade liberalisation and is moving closer to international trade practice.

Different countries might claim various targets of trade policy reforms. Many reform packages have the same goals but with different levels of priority. A common feature for the reforming countries, regardless of their different initial conditions, is that they want to accelerate the development process. Trade policy reform is considered a crucial breaking point for further development in an increasingly interdependent world. For this final effect, trade policy reform is in most cases expected to (1) expand exports, (2) improve the efficiency of resource allocation, (3) enhance international competitiveness by improving technological capabilities, (4) help domestic economic stabilisation by increasing export revenue, and (5) establish a neutral or freer trade regime. Among these objectives, export expansion is the priority in most trade policy reform cases. With regard to the basic components of trade policy reform, China shares many similarities with other reforming countries. What distinguishes China from other reforming countries is the reform approach. That is, China's initial economic conditions and ideological inheritance.

Concerning China's situation before reform, a wide range of trade policy reforms were needed, simply because the starting point was a centrally planned trade regime. In particular, the lack of the market forces in foreign trade posed the biggest obstacle to meeting standard trade policies, in line with international practice. It is not clear to what extent China was wrong to have ignored the importance of a fully functioning market system until as late as the early 1990s, some 15 years after the launch of reform. This neglect was a reflection of the fact that China was not prepared to touch all aspects of trade policy in the early stages of reform.

Trade policy reform, or more widely trade and economic liberalisation, may be started from very different situations. Historically, there have been at least two different patterns at the beginning of liberalisation: some countries have launched their reforms in a state of crisis, and others have begun reform under favourable internal and external conditions (Langhammer 1991). Most countries began to liberalise their economies in difficult circumstances, with a severely distorted price mechanism, resulting from government intervention over a long period. In this case, trade policy reforms were usually undertaken as a part of macroeconomic stabilisation measures, in response to economic crises faced by these countries. Latin America and Africa had a number of countries in this category. Other countries that conducted their trade policy reforms in favourable conditions were more

likely to move toward a more liberal trade regime. Most newly industrialised economies (NIEs) in trade policy reform were in this group. For these countries, their interests were in accelerating the pace of economic growth. Trade policy reform was regarded as a means to enhance productivity and competitiveness, enlarge external markets and integrate deeply with the world economy.

There is a third kind of country, those that started trade policy reforms neither in serious crisis nor in extremely favourable circumstances. China was in this category. Perkins (1991) noted that China's 4-5% a year GNP growth in the two decades prior to reform does not seem slow. Unlike those countries classified into the above two categories, China's trade policy reform centred on "catching-up" efforts. However, China's trade policy reform still had to address the problem of economic stabilisation following the exposure of its previously isolated economy to world markets. All trade policy reform measures were carried out with an emphasis on both economic stabilisation and increasing openness. Note that this situation at the beginning of reform enabled China to choose a moderate approach to trade policy reform; rather than a rushed transformation to overall liberalisation.

The adoption of gradual reform has also been due to the requirements generated by the "socialist characteristics" of the Chinese economy. The public ownership system and the long-lasting planning management have established a tradition of government intervention in China. Although the central planning control has significantly declined and the size of public ownership system has been reduced in the course of economic reform, there is no strong evidence to suggest that China will totally abolish these systems. Instead, China has clearly stated that capitalism and privatisation are not the goals of China's reform (Li Lanqing 1996, Li Zhongzhou 1996a). Given the existence of a sizeable public ownership system, government intervention is likely to play an important role in administering economic development in the country. In fact, China's trade policy reform over the past two decades, especially the 1980s, has been heavily driven by government intervention.

Indeed, the role of government intervention has been a key aspect in trade policy choice and has remained a debated issue. In fact, the above mentioned evolution of economic thought about trade policy has very much concerned this issue. In theory, free trade should enable countries to obtain the maximum gains from trade to promote economic growth and

increase national welfare. Trade policy, in this sense, should fully rely on the operation of the market mechanism, with no intervention in trade activities. In practice, the history of international trade has shown a basic (although phased) trend towards trade liberalisation, given the increasingly recognised positive linkages between trade and economic development. The widespread trade policy reform in developing countries since the 1980s reflects the importance of trade liberalisation in a country's development.

However, a pure free trade or *laissez-faire* regime cannot be found in the reality. Government intervention has been an ingredient of trade policy in almost all countries, to varying degrees. The extent to which trade policies can be liberalised is subject to the features of the trade regime pursued by different countries. Interestingly, for example, there are two contrasting interpretations of the Asian NICs' rapid growth in recent decades. The neo-classical view is that these economies have "got their prices right". This means that the most important factor in the NICs' growth is that these economies have relied upon the price mechanism to realise the efficiency of resource allocation (Woronoff 1992). The non-neo-classical explanation stresses the role of government in actively promoting export-oriented industrialisation (Amsden 1989; Wade 1990; Levy 1993). In reality, evidence of the market mechanism or trade liberalisation and of government intervention can be found in East Asian economies. The crucial point is that these two factors have been, in some ways, combined. Chinese economists and policy makers have laid great emphasis on the experience of East Asian economies, and in particular on the possibility of the coexistence of trade liberalisation and government intervention.

Consequently, the motives for trade policy reform in China have contained two prescriptively opposite themes. One is to liberalise trade to promote economic growth. Trade policy reform reflected the economic rationale of ensuring that sustained development in the country is consistent with its comparative advantage. Liberalised trade may enable the country to expand the economy, improve effectiveness and promote growth, through increasing utilisation of foreign resources. The other is to continue government intervention to maintain the public-ownership-based socialist economic and trade system. Not surprisingly, China sought (at least intended) an approach that served its dual requirements. China's trade policy reform has actually become government oriented, due to the fact that the government intended to use market forces but not fully to yield to them.



This begs the question: Is there another way towards trade liberalisation other than the neo-classical approach relying totally on the price mechanism? To provide evidence in order to answer this question, this study investigates the two following major issues. First, how has China reformed its trade policies with strong government intervention? Second, is China's government-oriented trade policy reform an effective effort that can lead the country to a freer trade regime in accord with its own conditions?

### ***The Significance of Theoretical Issues for China's Reform***

As mentioned, free trade (or trade liberalisation), which is much appreciated by the mainstream contemporary economics (namely neo-classical economics), has been regarded as the target of China's trade policy reform. Regardless of the gap between China's liberalisation attempt and the principles of western mainstream economics, China is moving towards freer trade. Therefore, it is important to assess how much China has achieved, and will achieve, in liberalising its trade policies in accordance with the standard principles of free trade.

This attempt to apply free trade theory to research on China's trade policy reform does not mean that free trade theory has been the dominant ideology guiding Chinese economists and trade policy makers. For some other reasons relating to their ideological issues and special development affairs, Chinese economists and policy makers have tried to find support for their requirements of protection, late liberalisation and government intervention in other non-orthodox theories. Reasons for China's attitude toward western economic theories should be noted.

First, China's economy is in a stage of transition from a centralised economy to a "socialist market economy". Many industries under previously planned system were closed or protected. The adoption of the open-door policy was based on the desire to promote economic development by adjusting the growth mechanism, rather than directing the country toward a liberal economy. The concepts of "market economy" and "free trade system" as stated by Chinese government will be imbued with strong "Chinese characteristics". It is unrealistic, at least up to the present, to expect that China's trade policy reform will fully follow the instruction of free trade theory.

Second, although free trade, which is thought optimal, seems to dominate the ideology of world trade policy, today's international trading system is not a "pure" free trade system. Trade protection and government intervention, in various forms, have significant influences obstructing trade liberalisation. The fact that protection measures co-exist with free trade policies in almost all countries enables China to have certain reservations in its course of trade policy reform.

Third, traditional trade theories are dependent on some assumptions that remain some distance from reality. Based on this gap, both orthodox and non-orthodox economists have tried to explore and debate the unresolved issues. Apart from the development of neo-classical international economics, there are also some other theories offering different explanations of trade policies. Moreover, applications of trade theories in an individual country also have to fit the special circumstance of the country. These theories will certainly be reflected in the thinking of Chinese economists and policy makers on trade policy reform.

As noted, this study places an emphasis on China's experience of trade policy reform, rather than providing a perfect theoretical interpretation on the basis of a single theory. Instead, due to the various motives behind China's trade policy reform, the theoretical framework for the analysis has to be open. However, again, free trade theory remains the main grounding for this study. Certain effort is paid to seeking a connecting point between various theories, for a better interpretation of China's experience.

### **1.2.3 The Structure of the Thesis**

In this thesis, the theme of China's trade policy reform is dealt in the following way: The shift of trade strategy as an aggregate reflection of changes in trade policy is the starting point of this study. However, due to the fact that China's trade policy reform has been adopted and carried on in a process of economic transition, an examination of trade-related institutional reforms must be given before starting the analysis of trade strategy shift. For the same reason, some discussion of the trade regime is logically included in this study, where applicable and appropriate. Following the analysis on general trade policy (trade strategy), the main body of research investigates how China has moved towards trade

liberalisation, through detailed analysis of changes in trade policies. This is followed by an examination of the effects of China's trade policy reform from both domestic and international perspectives. A conclusive evaluation of China's trade policy reform is given at the end of this thesis.

The remaining chapters are arranged as follows: Chapter 2 examines institutional reform in the field of foreign trade which is regarded as a precondition of, and support to, trade policy reform. Chapter 3 reviews the foundation of trade policy choices — foreign trade strategies — in order to explain the general trend of China's trade policies. Chapters 4 and 5 provide a detailed examination of China's trade policy changes and their impact on trade growth. Chapter 4 deals with the aspects of export policies while Chapter 5 concerns the changes in import policies. The following two chapters, Chapters 6 and 7, discuss the impact of China's trade policy reform from domestic and international perspectives. Chapter 6 conducts a series of statistical and econometric analyses, concentrating on the relationship between trade policy reforms and China's economic performance, while Chapter 7 discusses the international impact of China's trade policy reform and the role of external factors in the reform process. Chapter 8 draws some conclusions relating to China's experience and the direction of China's future trade policy reform.

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[1] The ratio of foreign trade to GDP should be treated as a nominal degree of openness. The real significance of this indicator needs to be further analysed in combination with the trade pattern. In the case of China, there was a large portion of foreign trade related to processing trade. Without appropriate adjustment, the ratio of foreign trade to GDP may cause an overestimation of the real degree of openness. For a detailed analysis of the real degree of openness see Chapter 6.

[2] China officially applied for its status in GATT in 1986. The GATT was replaced by the WTO from 1 January 1995. After then China's application became to join the WTO. In this study, where relevant, China's application may be expressed as relating either to GATT or to the WTO as appropriate. Otherwise the expression used will be GATT/WTO.

[3] The theory of comparative advantage was reformulated in terms of opportunity costs by Haberler (1929).

[4] As written by Haberler (1936), "Since Mill gave his approval, the infant-industry argument has been accepted in principle by many Free Trade economists" (quoted by Corden (1973), reprinted in Corden 1997, p. 139). Evans (1989, 1991) provided brief reviews on the subject that certain interventionist arguments have been sheltered in neo-classical theory.

[5] The five leading authors of the neo-liberalism are Balassa, Bauer, Krueger, Lal and Little, according to Colclough (1991), pp. 5-6.

[6] "Learning-by-doing" is sometimes treated as an argument for protection (see for example Dornbush 1992). It may be true that protection will be called for if the "learning-by-doing" activities are based on IS strategy and on the imperfections of capital market. In such a circumstance, firms are easily tending to seek "infant industry" status for protected development and likely to be reluctant to engage in the development of the productivity. However, it is not

necessary to provide protection for all "learning-by-doing" activities. On contrast, openness in trade may shorten the period of "learning-by-doing" and force firms to concentrate on its own research and development based on what they have learnt.

[7] In the Uruguay Round, the developed countries made average trade-weighted tariff cuts of 40% on industrial products. For developed markets as a group, the tariff average is scheduled to be reduced from 6.3% to 3.8%. For developing economies, a reduction of ceiling rates for tariffs leading to a decline of 30% in the trade-weighted average tariff.

[8] The periods for these stages are that, as classified by Corden (1974, 1997), the first stage lasted until the end of the 19th century, followed the second stage active until the 1960s, and afterwards the third stage.

[9] The "theory of the second best"(Lipsey and Lancaster 1956) demonstrates that if one or more conditions for Pareto optimality cannot be achieved due to some distortion or constraints, the other conditions also will not be necessarily satisfied for a constrained (second-best) optimum. A constrained optimum can be roughly understood as the possible maximum to be achieved under the existing conditions in the reality.

[10] It is impossible to obtain a perfect list of literature on the effects of trade policies since the amount of work in this category is extremely huge. But it is worth to mention some important work. On general cost of protection, see the work of Corden and that of Johnson in various years. On effective protection, see Corden (1966, 1971, 1974, 1997), Balassa (1971), Bhagwati and Srinivasan (1973). On tariffs and quotas, see Balassa (1965), Bhagwati (1969), Bhagwati and Ramaswami (1963), Corden (1966, 1997). For a survey on partial or whole of the topic, see Baldwin (1984), Corden (1984), Krueger (1984, 1997), Havrylyshyn (1990), Bruton (1989), Bliss (1989), Greenaway (1988), Erzan *et al.* (1989), Anderson (1994), Anderson and Neary (1994). With regard to trade policy reform, see Thomas and Nash *et al.* (1991), Papageorgiou *et al.* (1991), Rodrik (1992, 1995), Dean *et al.* (1994).

## 2 Institutional Reform in Foreign Trade

The most important feature of China's economic reform has been decentralisation. Decentralisation has had two major aspects. One was the deregulation of central government administration over economic activities. The other was the emergence of the market mechanism in the national economic system. In the field of foreign trade, decentralisation first led to institutional reforms and then resulted in many trade policy changes. This chapter concentrates on the institutional reforms in the foreign trade sector.

### 2.1 DEVOLUTION OF TRADING RIGHTS

#### 2.1.1 Institutional Reorganisation

Prior to reform, China's foreign trade was centrally controlled by the Ministry of Foreign Trade (MOFT) and conducted through some twelve state-owned foreign trade corporations (FTCs). Export producers and the consumers of imports lacked direct interaction with world markets. Consequently, export producers could not adapt their products to the needs of the world market and domestic producers could not introduce and use foreign advanced technology and equipment properly or efficiently. The potential development of foreign trade was heavily constrained and so was economic growth.

#### *Administrative Adjustments*

Because of its institutional setting, the starting point for China's trade policy reforms was different from those of other developing countries. The prerequisite of trade policy reform was to transform the centrally planned foreign trade system to a more liberalised one. As the first step towards liberalisation, the decentralisation of foreign trade management took place soon after The Third Plenum of the 11th Communist Party Central Committee held in late 1978, although at the beginning it was only a trial measure.<sup>[1]</sup> A highly significant event was that, in July 1979, the Central Committee of the Party and the State Council jointly issued a document which allowed both Guangdong and Fujian provinces to start reforms ahead of other provinces through implementing "special policies and flexible measures". The implementation period was five years from 1979 to 1984 and then extended for another five years from 1985 to 1989 (Gu Mu 1985). The main components

of the special policies were to (1) implement the “Budgetary Contracting Systems” so that the provincial government should sign a contract with the central government to fix the amount of revenue remittance for a specified period and to take responsibility for local fiscal revenues and expenditures; (2) expand local authority over the management of foreign trade and other foreign economic activities; (3) grant authority to the local governments to deal flexibly in the areas of finance, materials, labour, wages and prices; and (4) establish special economic zones in these two provinces (Lin Ruo *et al.* 1992). Then, through the implementation of special policies and flexible measures, both provinces began to reform their trade systems.

Following the opening-up and reform of foreign trade in Guangdong and Fujian, also since 1979, the administrative devolution extended to some other coastal provinces and cities. By January 1981, three municipalities (Beijing, Tianjin and Shanghai), four provinces (Guangdong, Fujian, Liaoning and Hebei) and one autonomous region (Guangxi) were granted the rights to establish their own trading enterprises to operate foreign trade within their jurisdictions. Although these local FTCs were under the dual leadership of the local governments and the MOFT, the real significance was that the state trade monopoly was beginning to be dismantled.

At the central government level, institutional changes also signalled the progress of reform. In 1979, some administrative agents related to foreign trade including the Foreign Investment Control Committee (FICC), the Export and Import Management Committee (EIMC), the General Administration of Customs (GAC) and the General Administration of Foreign Exchange Control (GAFEC) were established. In 1982, a new Ministry of Foreign Economic Relations and Trade (MOFERT) was established to replace the old MOFT and absorb several departments including the FICC, the EIMC, and the Ministry of Economic Relations with Foreign Countries (MFERFC). In 1983, to help with the decentralised management of foreign trade, the MOFERT dispatched special representatives to the four main ports of Guangzhou, Shanghai, Tianjin and Dalian. All these agents took an active role in co-ordinating and promoting the process of decentralisation.

The aim of decentralisation of foreign trade was to break up the existing state trading monopolies. However, decentralisation before 1984 was simply a devolution of

administrative powers from central government to provinces and ministries. No significant measure had been taken to separate trade enterprises from their administrative authorities.

### ***Transforming Foreign Trade Enterprises***

On 15 September 1984, the State Council approved a MOFERT report proposing reforms in the foreign trade system. This led to a new phase of trade reform aiming at: (1) separating FTCs from their administrative departments, (2) developing an “agency system” in foreign trade operations, (3) simplifying the contents of foreign trade plans, and (4) combining industrial production, technological progress with foreign trade and linking up export and import activities (*People's Daily* 20/9/1984). The core task was to transform FTCs into independent entities. Foreign trade administrative departments (MOFERT and the provincial committees) were to be responsible for making general policy, drafting trade plans, issuing export and import licences, and co-ordinating all related aspects. Correspondingly, all FTCs, as independent entities, would handle foreign trade as a part of their day-to-day functions and be responsible for their own profits and losses.

Unfortunately, due to inadequate reforms in relevant areas, especially in fiscal and financial sectors, the effect of separating FTCs from their administrative departments was unsuccessful. Most FTCs continued to operate under the supervision of their higher administrative departments. Direct government control remained the main tool of foreign trade management. It was for the same reason that little progress was made on developing the agency system and integrating production and technology development with foreign trade in this period.

With regard to the lack of incentives for FTCs to promote the growth of exports, in 1988, the State Council decided to apply the “contract responsibility system” to the foreign trade sector, after the successes of the system in agricultural, industrial and commercial sectors. The features of the responsibility system in the foreign trade sector included: (1) Most local branches of national FTCs were transferred to local governments, who decided on their tasks. (2) All relationships between government and FTCs, FTCs and production enterprises were ensured by signing contracts in which rights and responsibilities relating to foreign trade production, circulation and management were defined for each part. (3) The main contents of responsibility contracts were the amount of foreign exchange earnings, the remittance of foreign exchange being turned over to the central government, and the

balance of profits and losses from trade activities. (4) All localities, departments and enterprises were entitled to freely use the foreign exchange they retained, according to state regulations. (5) The MOFERT committed itself to increase the use of market instruments, such as prices, exchange rate, taxes, tariffs, interest rate, export credit, etc., replacing mandatory administrative controls over foreign trade. Improvements in the duty drawback system and the trade agency system were also proposed.

The process of decentralisation was continued alongside the implementation of the contracting system. Most provincial and local branches of national FTCs were converted into separate FTCs under the supervision of provincial or local governments. In some ways, FTCs were granted greater rights to handle foreign trade themselves, as well as having much clearer responsibility for their own operations. In addition, three foreign trade industries (Light industry, Handicraft industry and Garment industry) were selected as experimental bases to test the system of FTC-responsibility for profits and losses.

The initiatives of the contract responsibility system were: (1) to provide impetus for enterprises and workers to increase production, (2) to stabilise and increase government fiscal revenue, and (3) to strengthen the enterprises' ability to rationalise their behaviour by combining responsibility, rights and profits at enterprise level (Xun Dazhi 1990). However, the last two goals have not been completely achieved, although the system did arouse great enthusiasm in enterprises and workers to expand foreign trade.

In 1991, China started a new round of foreign trade enterprise reform. The main goal of this programme was to establish an operating mechanism in which FTCs were expected to be really responsible for their own profits and losses. The foreign trade and production enterprises were to embark on the road of independent operation, self-responsibility for profits and losses, self-restraint and self-development. The reform approach in the 1990s has been shifted onto the right track for unified trade policies, equal competition, integrating industries with trade, and the agency system. Great effort has been made to establish a market-based foreign trade system, with emphasis on trade policy reform.

### **2.1.2 Regional Strategy of Openness**

Implementation of a regional strategy of openness was also a feature of the devolution of trade administration. Differential policies were applied to different regions. This did not



imply any bias to the specified areas, but was due to the desire for gradual reform. China's experiments started from special economic zones (SEZs), moving then to coastal open cities before being extended from eastern areas to central provinces and western regions.

### ***Special Economic Zones***

The establishment of SEZs began the reform in foreign trade and the opening-up of the national economy. It also signalled the introduction of regional strategies in trade reform. In February 1979, an industrial processing zone appeared at Shekuo, Guangdong Province. The initiator, a Hong Kong-based corporation named China Merchants Steam Navigation Company which is owned by the Ministry of Transport, intended to use its experience of operation in the market economy, as well as experience of special economic zones in foreign countries, to develop an export processing zone. This idea was approved by the Central Government. Soon, this event led to a further strategic decision to establish four SEZs in Guangdong and Fujian provinces.

In July 1979, the State Council approved the proposal to establish four "special export production bases" (the name was changed to "special economic zone" in the following year) in Shenzhen, Zhuhai, Shantou of Guangdong Province and Xiamen of Fujian Province. In August 1980 the Standing Committee of the Fifth National People's Congress approved the "*Regulations on the Special Economic Zones of Guangdong Province*" that formally announced the establishment of SEZs. Xiamen SEZ was established in Fujian Province in the same year. The area of these four SEZs was 338.37 square kilometres at the time of their establishment and then extended to 632.1 square kilometres. In April 1988, the National Congress approved the elevation of Hainan Island, which has 33,931 square kilometres and previously belonged to Guangdong Province, to provincial level and the fifth SEZ.

The establishment of the SEZs was to exploit the geographical advantage of these areas adjacent to Hong Kong, Macao and Taiwan and the linkages with overseas Chinese to expand foreign trade and absorb foreign investment, through the implementation of special economic policies. In the early 1980s, the Chinese government set the goals for the establishment of SEZs: the SEZs would be developed as a "laboratory" of economic reform, a window for China's open policy and a bridge for interaction between China and the world economy (Zeng Muye *et al.* 1993, p.203). The SEZs have carried out each reform one

step ahead of other areas, as well as enjoying preferential policies. Through the practice of reform and opening-up to outside world, the Shenzhen SEZ for example has successfully functioned as such a “laboratory”, “window” and “bridge” (Fukasaku and Wall 1994). The SEZs’ successes have generated significant impact on China’s economic transition.

### ***Open Cities and “Economic and Technology Development Zones”***

The establishment of SEZs has actually been a significant measure in the opening-up process. However, the areas of SEZs represented only a limited portion of China’s territory. The implementation of the open policy needed to be expanded to a larger area. On 30 April 1984, the Political Bureau of the Party’s Central Committee formally decided to open 14 coastal cities<sup>[2]</sup> and Hainan Island to foreign countries, as well as to continue the experiment of the SEZs. Adopting the experience of SEZs, these newly open cities were allowed to set up economic and technological development zones (ETDZs) in which some preferential policies of SEZs could be implemented.<sup>[3]</sup> The special facilities granted to the open cities were (1) to provide preferential conditions for foreign investment, and (2) to expand the brief of the open cities to include economic and technological co-operation with foreigners.<sup>[4]</sup> Open cities were expected to introduce and develop technology-intensive or new industries to make use of the human technological resources there. The difference between ETDZs and SEZs was that the ETDZs were to concentrate on reshaping the existing industries in those cities by introducing foreign technology and investment. At the end of 1984, the State Council approved the proposal for Tianjin ETDZ. Since 1985, most open cities have set up ETDZs, one after another.

Later, various forms of special economic zones were used to speed up the opening-up process. By 1997, there were 32 ETDZs, 52 high and new technological development zones (HNTDZs) and 14 free trade zones throughout the open areas (Qin Shi 1997, pp. 78-84). They have been given the same preferential policies as the open cities.

### ***Coastal Area Development Strategy and the “Ladder-Style” Structure of Openness***

The establishment of SEZs and the opening-up of coastal port cities reflected China’s view that the opening-up of the economy could be gradually carried out from some test areas to larger areas. This “pushing-up” policy was continued by expanding open areas and eventually formed the “ladder-style” structure of openness in the second half of the 1980s.

In January 1985, the Yangtze River Delta, Peal River Delta and Xiameng-Quanzhou-Zhangzhou Triangle Area were selected as parts of the "coastal economic open areas". These areas were proposed to develop outward-looking economies following a "trade-industry-agriculture" sequence, in order to meet the needs of international markets. Important tasks were to expand exports and to increase export earnings. The special privileges granted to them were similar to those in the 14 open cities. In October 1987, Shandong Peninsula and Liaodong Peninsula were added to the list of open areas.

During the first half of 1988, the idea of "joining the international great circle" and the economic development strategy of the coastal regions were popular in China. More and more counties and cities were included in the proposed "coastal economic areas". By the end of the 1980s, the coastal economic-development areas made up of SEZs, open cities and open areas covered 290 cities and counties, with an area of 420,000 square kilometres and a population of 220 million (Li Haijian 1994). In addition, in early 1990, the State Council approved the establishment of the Pudong district of Shanghai as another special economic development area. This decision aimed to restore the central city of Shanghai as an international economic centre in the Far East. Moreover, the process has never been limited to the eastern coastal areas. Between 1990 and 1992, a large number of inland cities and areas were opened up to the outside.

Having set up open areas in all the eastern coastal provinces, and then the inland areas, China has in fact formed its "ladder-style" frame of openness. The increase in open areas indicated that China's move towards opening up the economy to the outside world has been strong and permanent. The target of the regional strategy was to build an export-oriented eastern area with rational industrial structures, advanced science and technology, and a prosperous economy. While developing the local economy, the eastern area was expected to bring up the inland areas through the transfer of introduced advanced foreign technology and the capital inflows, as well as through industrial linkages between these areas. In the past reform period, the eastern area, especially the SEZs, provided assistance in the financial, technological, managerial and personnel training areas to the inland regions and promoted their economic development.

Besides others, an important element relating to the opening-up decisions was the availability of trade rights. All these open cities and areas were granted power to operate

trade under the preferential policies they were given. In this way, decentralisation in foreign trade was accelerated.

### **2.1.3 The Real Significance of Administrative Devolution**

#### ***Forming the Base for Freer Trade***

How important was the administrative devolution in the process of China's foreign trade reform? Three points should be taken into account. First, the decentralisation of administrative authority was a significant step to breakthrough the previously centrally-planned economy. It divided the rigid, unified and centralised economic regime into many active economic entities at provincial and local levels, and formed the basis for the "regional open strategy". In this context, the institutional adjustments became the precondition of China's opening-up process. This policy made it possible to open the economy to other countries in some experimental sites and then extend openness to other areas. Overall, the national economy has become more open than it was.

Second, besides the transfer of administrative power to provinces and localities, trading rights, in particular those rights involving trade practice, have been partially passed on to the enterprises. Although the granting of trading rights in all cases was subject to administrative authority's selective approval and supervision, the significant effect was that a number of FTCs could engage in foreign trade as relatively independent entities. This was also an important condition for facilitating market reforms, given that an increasing number of new economic entities, as major participants of market economy, have been created.

Third, the implementation of the contract responsibility system in foreign trade was, from a historical viewpoint, a continuation of the delegation of authority and of benefit sharing to the lower levels. It was also a prelude to the further reforms of trade enterprises. The most important effect was that, at various levels, responsibilities, rights and profits relating to foreign trade activities were gradually interlinked. It showed that China's foreign trade reform was shifting to an emphasis on enterprise efficiency. Many new practices, such as competition mechanisms, bidding and the autonomous rights for employing directors and staff members, were applied to ensure the successful fulfilment of contracts. It also gave greater initiatives to localities, departments, and FTCs to improve their internal systems, to increase economic efficiency and to expand their exports.

### *The Limits of the Contract Responsibility System*

Another question is to what extent did the trading rights devolution contribute to China's trade reform? The devolution was targeted at distributing trading rights at two levels: local trade management and enterprise operation. The former was achieved through administrative devolution, as discussed above. The latter was the content of enterprise reform. The implementation of the contract responsibility system represented the early effort to turn FTCs into independent operating entities. But the constraint seemed to be that the contract responsibility system was based on administrative forces instead of on the market mechanism. Many non-market factors were actually involved in the process of contract making. Therefore, the implementation of the contract responsibility system could not turn the FTCs into independent entities acting in markets.

First, the contracts were made on the precondition that differences in export targets, export costs and foreign exchange retention between regions, departments and enterprises were recognised. These differences became a source of unequal competition. Furthermore, the implementation of the system, accompanied by the decentralisation of management authority, strengthened and legalised the administrative intervention from local governments and departments in foreign trade.

Second, the targets of responsibility contracts emphasised export earnings by fixing the volume of exports, the creation of export earnings and the remittance of foreign exchange from FTCs. Given that the export commodity structure could not be changed in the short-term, many FTCs, therefore, fixed their gaze on a few exportable items, such as textiles and clothing products, which were usually controlled through licences and quotas. FTCs, and local governments also, made great efforts to strive for more quotas from the MOFERT or just ignored the quotas controls to export at higher levels. The development of a new export product was thought a thankless task. This resulted in an effect encouraging quantitative expansion of exports rather than improving export structure and competitiveness.

Third, while FTCs were assumed to be independent accounting units, they found themselves in an unusual position. On the one hand, they had to face incomplete domestic market conditions due to the slow progress of reforms in the areas of prices, taxes, finance, and fiscal regime. On the other hand, FTCs were required to undertake the risk of international market changes. FTCs had to adapt the changing world market and unchanged

domestic enterprises simultaneously and to transfer fluctuating international prices into fixed domestic prices. The role of FTCs as a “buffer” between international markets and domestic enterprises increased the complexity and difficulty involved in being responsible for their profits and losses, unless the contract targets were fixed at much lower levels.

The experience of practising the contract responsibility system in foreign trade was not totally successful. The key reason was that the administrative devolution could not build an effective mechanism as in the market economy to regulate FTC behaviour. Although many reform measures in taxation, finance, planning and foreign exchange were adopted, the effort to establish a market economy was weak until 1992 when the market economy was considered the reform target and incentive trade policy reforms were carried out.

### ***Biased Decentralisation***

When analysed in more detail, the limits of administrative devolution become apparent. One question concerns the interaction between the regional strategy and the devolution of trading rights. It seemed that the devolution of trading rights was just an accompaniment to regional strategy. The extent to which trading rights were granted to localities or enterprises was treated as individual case. Once the central government decided to open up an area to the outside, this area would be granted greater authority to engage in foreign trade. But the implementation of the regional strategy, with the differential open policies for different regions, has raised some problems.

First of all, the degree of openness varied in the eastern, central and western areas. Of the total 424 open areas approved by the State Council in their various forms (e.g. free trade zones, SEZs, ETDZs, open cities, etc.), by the mid-1990s, 360 were located in the east, while only 36 were in the central areas and 26 in the west. Regarding foreign trade, the eastern areas accounted for 87% of the total exports and 91% of the imports to the country, while the proportions in the central area were 9% and 7%, and only 4% and 3% in the west (Guo Keshai and Li Haijian 1995). Eastern areas had a significant advantage in becoming open to the outside world earlier. But more than a decade of preferential policies in the east has, relatively, worsened the development in western areas. The difference between the eastern and the western areas has increased during the reform period.

Second, the regional openness strategy brought about a situation where different areas within the country were given unequal conditions of production, unequal investment policies, and unequal control over foreign trade. The man-made unequal competition caused an economic blockade and market separation between regions. It was always the case that the FTCs in more-open eastern areas would like to obtain export resources (exportables) from less-open inland areas, in order to enjoy the benefit of cheap prices fixed by the government. On the other hand, inland less-open areas were keen to develop their own regulations and preferential measures to compete with other areas for attracting foreign companies or promoting exports from local FTCs. In some inland areas, preferential treatment was claimed to be even higher than in the coastal areas. In addition, provincial and local authorities were increasingly concerned with local interests, due to their responsibilities for local development under the "budgetary contracting system". To protect their benefits, local governments strengthened administrative intervention in economic activities. This situation increased the difficulties of improving the effects of foreign trade and retarded the transformation of FTCs into independent operating entities.

Finally, the focus of the preferential policies encouraging export expansion of labour-intensive light and textile industries in the eastern region, together with an import substitution policy protecting heavy and chemical industries which are mainly located in inland areas, slowed the structural upgrade of exports. In 1991, for example, light industries accounted only for 48.9% of China's total industrial output but exports of light industrial products were as high as 73.0% of total manufactured exports (Wang Xinkui 1994a). Until 1995, most of China's manufacture exports remained low value-added products (*People's Daily*, overseas edition, 13/1/1996).

## **2.2 DEVELOPING AN INDIRECT MANAGEMENT SYSTEM FOR FOREIGN TRADE**

### **2.2.1 The Decline of Central Planning**

Another important aspect of decentralisation was the changing role of foreign trade planning. Before reform, all foreign trade agreements were mandated by the central planning system. Once the trade plans had been made out by the central government, all FTCs had to be responsible for the fulfilment of the plans but not for the profits and losses from trade.

The procedure for foreign trade planning included the following steps: First, the MOFT and the State Planning Commission jointly made plans for exports and imports according to the demand of national economic development in physical terms. Second, the approved trade plans were transmitted to the specified state FTCs who were responsible for fulfilling the plans, contacting the relevant foreign enterprises and signing the import or export contracts. Third, the state FTCs purchased the agreed products according to state-fixed prices and then exported them, or imported the planned import items and then distributed them to the final users at state-fixed domestic prices. In such a procedure, foreign trade plans had to cover a huge number of import and export commodities in quantity, physical specifications and prices, as well as the specified executive channels (FTCs). The system employed a large amount of human and material resources. However, the biggest problem was that the trade plans might not fit the real needs of national development. The foreign trade plan system actually generated a confusion of administrative power and enterprise function, and caused a separation between production and commercial spheres.

Since the end of the 1970s, the reform of the foreign trade planning system has been an important touchstone, because it has reflected to some extent the progress of trade liberalisation. Reform of trade planning has gone through a difficult process. Until 1984, China maintained an almost completely controlled planning system for foreign trade, while central planning had been increasingly reduced in the agricultural and industrial sectors. A government statement is evidence of such an unchanged foreign trade system:

“The People’s Republic of China is a country in which the planned economy is in practice. Imports and exports are operated according to plans determined by the state. The ratio of foreign trade to GNP is very small. The products produced in China are mainly to meet the needs of the domestic market and few of them are designed to be exported. Export is for import and import is dependent on the needs of domestic economic development. ... Export products are purchased at domestic prices and exported to the world market at international prices. Import commodities are purchased at the international prices and distributed to consumers at domestic prices. There are no direct linkages between domestic prices and the international prices of the import and export commodities.” (*People’s Daily* 1/12/1983)

Accompanying the deepening understanding of market mechanisms, has been the decline in the role of central planning. Around mid-1980s, the foreign trade planning system was reformed but still remained the core of China’s foreign trade regime. The main change was the division of foreign trade plans into two categories, namely mandatory plans



(*Zhi Ling Xing Ji Hua*) and guidance plans (*Zhi Dao Xing Ji Hua*). The former were state orders with a legally binding nature and specified in physical terms, while the latter were a non-compulsory requirement with indirect government adjustment through various economic levers. Guidance trade plans were mainly applied to exports. Unlike mandatory export plans, a guidance export plan fixed the value of exports without their composition or export channel. Correspondingly, there was no guarantee for export producers in obtaining inputs from state materials distribution system at fixed prices. Following the introduction of guidance export plans, in 1985, the MOFERT stopped drafting and issuing mandatory plans for the purchase and distribution of export products.

The reform of the foreign planning system gave greater freedom to local government and even FTCs. The scope of state foreign trade planning was continuously reduced. As a result, by 1988, the planned share of exports had fallen to 45% and that of imports to 40%. (Xiao Zhuoji *et al.* 1992, p. 168). After 1994, all mandatory foreign trade plans were completely abolished. The government only produces a guidance plan for the total value of exports and imports, the foreign exchange quotas from export earnings and import expenditure.

### **2.2.2 The Emergence of Market Mechanism**

As the scope of central planning was gradually reduced, market forces were given much more importance in economic operation. This crucial but gradual progress mirrored the cognitive process of the relationship between the “planned economy” and the “market economy” throughout the reform period. At the beginning, Chinese economists and policy-makers avoided using the term “market” in their work and policy decisions because “market”, or “market economy”, was thought to be the equivalent of capitalism. However, analysis of the disadvantages of the traditional planned economic system suggested that the key issue of decentralisation was just how to deal with the conflict between the planned economy and the market. To identify the different interests at the various levels of local government, enterprises and even individuals, it was necessary to introduce some indicators in terms of market economy to improve macro-economic control. Since over-centralisation caused inefficiency in the economy, it was thought the only solution was to reduce the scope of planning and to expand that of market forces. Therefore, both in practice and in theory, the economic reform models were presented in order from a “planned economy with the assistance of market adjustment” (1982) to “planned commodity economy” (1984), then

to one in which “the state regulates the market and the market guides the enterprises” (1987) and finally the “socialist market economy” (1992).

To make a market system work, the essential elements are: (1) free flows of intermediate and final goods, (2) a price mechanism based on demand and supply forces, (3) rational enterprise behaviour in accord with the rules of the market, (4) competition among enterprises, and (5) macro-economic stability (Perkins 1991). Of course, all these elements should be collected together. Once such an economy has been established, the price mechanism would play a mandatory role in production, circulation and income distribution. So enterprises could act as independent entities mainly responding to the changes of price signals.

Looking at the evolution of the reform target, a clear trend in China's reform was to increase the role of market forces. Through sustained reform, a multi-fold market system has basically been established as the base of the “socialist market economy”. More than 90% of industrial enterprises are engaging in some form of contracting operation. This has meant that enterprises have been forced to enter market competition. The government is no longer to “operate” enterprises directly. According to statistics, before 1979, the value of industrial production fixed by the state mandatory plan accounted for 95% of the total value of industrial production. During 1979-1992, this proportion has been reduced by more than 85% to less than 10%. The type of raw materials distributed for production by the state has been reduced from 256 to 19, and the kinds of Category One commodity purchased through the state unified plan have also been decreased from 65 to 20. Of the commodities purchased or distributed by the state, about 70-80% were subject to the adjustment of the market mechanism (prices), hence only about 20-30% of industrial products were controlled through the state plans (Cao Yuanzheng 1994).

In addition, by the mid-1990s, state-owned enterprises (SOEs) accounted for less than 50% in industrial sectors while the non-state sector including town and village economies (TVEs) grew rapidly. The growth of TVEs was basically dependent on the market system, given that all inputs and products are purchased and sold through markets. By 1994, the share of TVEs output in total national industrial output was 42.04%. In this aspect, together with the marketisation of state-owned enterprises' economic activities, the market mechanism has played a major role in the Chinese economy. Moreover, 85% above of

product prices were determined by market force of demand and supply (Yang Qixian 1994; Goodhart and Xu 1996). Government control of the macro-economy has been gradually shifted to indirect measures. Facing the severely overheated economy in 1993, for example, China for the first time used financial measures as major tools of macro-economic control. In the 1993 adjustment, China twice increased the interest rates on savings and loans in May and July of that year, reintroduced “inflation proof savings” for three-year and above fixed-term deposits, and allowed free selling and buying of foreign exchange in foreign exchange swap centres. These measures, combined with other necessary administrative measures, have been proven effective in adjusting macro-economic conditions (State Statistical Bureau 1994).

In foreign trade, market forces also increased their importance. Prices of exportables are mainly subject to the level of domestic markets. Competition in purchasing goods for export sometimes causes the prices to go up, due to limited supply. State-pricing and the dual price systems have been minimised. After 1994, export purchasing and distribution plans were eliminated. Among all export commodities, the number subject to direct state control decreased from 900 in 1980 to 20 in 1995. Commodities subject to export quotas and licences was 143 in 1995 (MOFTEC 1994; Xu Yu and Ma Lijun 1996). On the import side, in 1995, import quotas were only applied to 16 general commodity groups (133 commodities) and 15 machinery and electric product groups (168 commodities), compared with the situation before 1980 when all imports were mandated by the state plans (Lin Guijun 1996).

To realise the 1990s’ reform goals, contrary to the emphasis on administrative devolution in the 1980s, several important measures (trade policies, including the elimination of subsidies, the unification of exchange rates, tariff and non-tariff barrier reductions, which will be discussed in the remaining chapters) were taken to rebuild the foreign trade regime based on market mechanisms. Much attention was paid to the development of market forces and relevant reforms — such as the exchange rate system and tariff structure — were introduced to match the reforms in foreign trade.

### **2.2.3 The Persistence of Government Intervention**

Although great progress was seen in the effort to establish a market system, it is fair to say that state-owned enterprises, either in the foreign trade sector or in other fields, could not act completely in accordance with the market principles even if they intended to do so.

The reason was simply that enterprises were still bonded to the administrative management system. There is a view held by many Chinese leaders and economists that the market is not a panacea for economic and trade reform. Market competition might mislead resource allocation and enterprise behaviour (Wang Shaoxi 1994). Therefore, government guidance and intervention are thought to be necessary to ensure the direction of reform.

Throughout the 1980s, China's trade reform was carried out under the precondition that government control should hold a dominant position, whilst the market mechanism would be considered a supplementary tool. Up to now, although the market economy has been the reform target, this principle has not really been abolished yet. A feature of China's trade system reform over the past years has seemed to be that the forms of management might be changed but the core of government control could not be phased out. But on the other hand, given that direct government control has been proven inefficient and incompatible with the market economy, China has put in a lot of work to establish a new indirect macro-control system over foreign trade. The reform measures were, as mentioned, the elimination of mandatory trade plans, the introduction of guidance trade plans, and the use of various economic and law instrument including tariffs, the exchange rate, and prices.

In analysing the persistence of government intervention (or control) over trade, two contributory factors and resulting problems are worth noting. First, in theory, the weakness of the market economy has been excessively stressed. From the viewpoint of traditional Marxism that provides the guiding idea of the socialist economy, capitalist market competition may lead to the absence of government intervention. Although a market economy (and competition) could be the model for a developing socialist economy, it will be effective only if it is combined with government planned guidance. "Under the socialist market economic system, it is necessary and possible for the state to strengthen its macro management" (Liu Rixin 1994). Some western economic theories developed in recent decades, such as "market failure theory", "managed trade" and "strategic trade policy" theory, have also provided support for government intervention. Some Chinese economists have used these theories to call for appropriate government intervention to improve trade structure, to ensure the increase of trade benefits for the nation, and to guarantee that trade liberalisation takes place under government control (Xue Rongjiu 1995; Hai Weng 1995; Zhang Shuguang *et al.* 1996).

Further, there was a confusion in understanding the concept of “market failure”. In western economics, “market failure” refers to the situation in a perfect market economy that departs from competitive equilibrium and Pareto-efficient outcomes. Put simply, market failure means that in some areas the principles of the market mechanism become ineffective. It is a fact that market failures exist in almost all market economies. However, these market failures may occur in limited fields such as pure public goods, goods with positive externalities or spillover benefits, natural monopolies and imperfect information (World Bank 1996, pp. 110-111). Government interventions designed to remedy these failures, therefore, should have a sectoral limitation. Considering the requirements of managed trade and strategic trade policy, government control or guidance should also be targeted at selected industries. In China, the situation is more complex. The ineffectiveness of the market in the Chinese economy rests in imperfections in the underlying market systems. Only a few of these may be counted as real “market failures”. It is not necessary and reasonable for China to maintain the current “all-directions” government intervention. Moreover, regarding the areas with dispensable government guidance, China also needs to reduce its excessive administrative control although in economics there is still a lack of conclusive standard defining the appropriate government intervention.

Second, in practice, several decades of running a centrally planned economy generated an “inertia”, so that both senior authorities and basic managers were used to the administrative command approach. Faced with the transition of the economy from plan to market, they seemed unable to adapt to the changing situations. Government intervention seemed not only to reflect the desire of the government to control the economy but also a motivation to control enterprise operation. On the other hand, the successful experience of government intervention in some countries, particularly Japan and Korea in their early period of development, strengthened the belief of Chinese people that government intervention could play an important role in economic and trade development.

Combining the above two factors, and in addition, the fact that foreign trade has long been considered a special sector with links to all aspects of the economy, China seemed not to be very keen to reduce government control over foreign trade. This attitude has at least generated the following problems. The first is the misunderstanding of the relationship between “destroy” and “establishment”. To establish a market economy, the first thing is to remove all barriers incompatible with the market system including excessive administrative

intervention. This is not to say that government intervention could not co-exist with the market economy but to recall that the operation of market mechanisms needs some essential preconditions, as mentioned earlier.

The second problem is the misunderstanding of the “East Asian experience”. Government intervention used by Japan and Korea was to complement markets rather than to replace them (Stiglitz 1996). Regardless of the differences and debate among economists, the fact that both government intervention and market mechanisms have contributed to economic growth is undeniable. What demands our attention here is the pattern in which these two factors co-exist. Unlike the case of China, there were relatively complete market economies in these countries. Appropriately balanced government interventions promoted and used the market economic system to improve efficiency. There are two totally different ways to combine market forces and government intervention. In Japan and Korea, the experience was to have a market system first and only then was intervention used. In China, strong government intervention already existed, but a complete market system has not yet been built up. There is not a lack of government intervention in China.

The third problem is that government intervention also generates failures — government failures. Even for a government intending to maintain a market system, some non-market factors such as political objectives, bureaucratic structure, imperfect information could lead to some government intervention against the market principles. Further, when there are genuine “market failures” to be corrected, it is also possible that government intervention may be poorly implemented.

Undoubtedly, there has been positive progress in transforming China’s economy and foreign trade by increasing the role for market forces. However, to develop a well-functioning market economy and to balance the forces of the market economy and government intervention, China certainly has a long way to go.

### **2.3 ASSESSING THE DECENTRALISATION IN CHINA’S TRADE REFORM**

The decentralisation of trading rights was a notable first step in China’s trade reform. The immediate and direct effects were that: First, the over-centralised state trading regime has been ended. An increasing number of trade entities has been created. Second, the scope

of central trade plans has been gradually reduced. Local governments and enterprises have been granted greater power to engage in foreign economic exchanges. Third, for adjusting and balancing benefits between regions and enterprises, market instruments have been increasingly employed in the government's macro-management over foreign trade. All these changes contributed to the ongoing construction of market mechanisms in the field of foreign trade.

In assessing the effect of institutional reform, however, a crucial point concerns the role of FTCs. After reform, the role of FTCs has been much improved. This can be seen from the growth of relatively independent FTCs as new entities in foreign trade and their increasing involvement in the market economy. But, equally, it is worth noting that a number of problems still exist. First, the property rights of FTCs and the relevant responsibilities remain unclear. Most FTCs are state-owned and remain government subordinates. The separation of enterprises from government, a problem examined more than 10 years ago, remains to be solved. Second, FTCs' business activities are mainly driven by government administrative forces and are only responsible for profits but not for losses. The function of the market principles has been heavily distorted. Third, enterprises' inner management system remains backward. Most FTCs are characterised by small-size, dispersed-operation and a single-product line. Many enterprises lack necessary incentives and rules to ensure efficient operation.

Several factors have contributed to the stagnated transition of FTCs. First, foreign trade has remained a "priority" sector under the government's close regulation. The only change is that direct government control by the State has been shifted to indirect administrative co-ordination. Provincial and local governments, rather than the State, take the responsibility for regulating the foreign trade within their territories. While lacking a complete market mechanism for indirect controls, the foreign trade sector has remained in public or state ownership to ensure the effectiveness of government intervention. Government controls over foreign trade was thought to be a way to maintain equilibrium in the balance of payments. Even as the contract responsibility system with its mandatory plans was nominally abolished, the fixed targets of exports, the amount of foreign exchange earnings and the quotas of foreign exchange to be turned over to the central government were still compulsory.

Second, the domestic market systems and the indirect macro-control system for foreign trade have not been completely established. Some necessary reforms in relevant areas including tariffs, foreign exchange, licensing, tax and financial systems remain to be further carried out to create a favourable environment for FTC reform. In such a circumstance, it is impossible for the State to adjust its foreign trade by using economic means such as credits, interest rates, tariffs and exchange rates. In contrast, the existing direct and indirect government subsidies for exports and “soft” restraints on enterprise accounting encourage the FTCs to rely on the government for financial support.

Third, most FTCs lack a production basis. Their main business is to purchase products from production enterprises and to export them. The separation of production and exports means that FTCs are unable to undertake risks in international markets. It is difficult for this kind of enterprise to become responsible for the profits and losses of their business.

China intended to make use of competitive mechanisms by creating new entities through devolving trading rights to localities and enterprises but failed to create an equal environment of competition due to the “half-way” effects of institutional reform in foreign trade. By decentralisation, trading rights have been partially devolved from the central government but have not been sufficiently passed onto enterprise level; Market forces have been introduced into the economy but have not yet been fully functioning so as to regulate trade behaviour. More importantly, the decentralisation seemed an attempt to devolve administrative powers to local governments rather than to create truly independent FTCs. This also reflected the fact that China has put more weight on the side of government control rather than developing a fully functioning market mechanism. Although many FTCs were granted greater rights to deal with trade activities, local or departmental administrative units, which replaced the role of the central government, were still supervising most foreign trade affairs. To this end, the key reason was the lack of a well-functioning market system. In other words, it has not been seen a sufficient reduction of government control over foreign trade.

Following the above analysis, the assessment can be made that China’s institutional reform in foreign trade has so far only been a partial reform which has resulted in the long-lasting incomplete transition of the foreign trade system. Although the market mechanisms have been introduced into the economy, government control remains one of the most



important features of China's foreign trade. Both the partially reformed government control system and the partially constructed market mechanisms are unable to perform properly.

This assessment implies that trade policy reform has not been fully supported by creating a favourable institutional environment. China's foreign trade institution now is a mixed system in which market forces and government administrative controls co-exist rather than being integrated. Or, at least, these two systems have not been matched with each other appropriately. The persistence of government control over foreign trade, together with the incomplete market reform, has retarded the pace of liberalisation and restricted the significance of China's trade policy reform.

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<sup>[1]</sup> On 15 July 1979, an article in the *People's Daily* presented the argument that: "Current foreign trade regime should be reformed. ... The reform of foreign trade regime must be carried out positively and cautiously. It is right first to conduct tests of reform at selected points and then to spread it throughout the nation gradually".

<sup>[2]</sup> In January and February 1984, Deng Xiaoping, with some other Chinese leaders, inspected Shenzhen, Zhuhai and Xiamen SEZs and appreciated the achievements the SEZs have made. After his southern tour, Deng suggested adding some places to the open area list and to try another form in implementing special economic policies.

The newly opened 14 coastal cities are Dalian, Qinghuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai.

<sup>[3]</sup> As Deng Xiaoping suggested, the newly added open areas won't be called SEZs but they can obtain some special policies similar to those in SEZs. See Zeng Jianhui (1984).

<sup>[4]</sup> For details see Ji Chongwei (1984).

### **3 Shifting Trade Strategy**

China adopted an import substitution strategy throughout the period from the establishment of the new republic until the commencement of the open-door policy, or even later. However, along with the opening-up of the economy, China also doubled her efforts to promote exports. The trade strategy, which reflects trade policy changes, has been shifted toward a mixed one. This chapter investigates the changes in China's general trade policy — trade strategy. The first section of this chapter comments on the changing position of import substitution in China's shift of trade strategy while the effects of import substitution in China are examined in the second section. Finally, the last section evaluates China's trade strategy in the reform period.

#### **3.1 IMPORT SUBSTITUTION STRATEGY IN CHINA**

##### **3.1.1 The Adoption of Import Substitution Strategy**

At the beginning, China's adoption of import substitution strategy reflected the special economic conditions in China and contemporary thinking on economic development at the time. In the early years of the post-war period, it was widely believed that development in developing countries needed to stress modernisation in industrial sectors, capital formation and planned management. It was thought that the developing countries could not develop their economies on the basis of the market mechanism, because the structure and the functions of market in developing countries were incomplete. State intervention and planned management became the only reliable force to accelerate capital formation and improve resource allocation for rapid industrialisation (see Krueger 1992, p.7, p. 40; 1993, p. 43; 1995, p. 7). Import substitution was considered an inescapable stage for industrialisation in low-income countries due to the lack of knowledge of foreign markets, the stringent quality requirements of international markets and the paucity of indigenous skills (Agosin 1993). In practice, most developing countries were pursuing policies of import substitution in the 1950s and 1960s.

The aims of the IS strategy were to enhance the domestic productivity to replace imports, to protect domestic infant industries and then to promote rapid industrialisation.

Under the IS strategy, capital goods were imported to build factories, and very often imports of intermediate goods and raw materials were employed in the production process. It is important to mind the relationship between trade protection and substitution activities in a traditional understanding of IS strategy, although an argument may be raised that import substitution is not necessarily across-the-board protection. It was fact that protectionist trade policies, such as high tariffs, tight quotas and an overvalued exchange rate, were usually used in IS strategy to promote domestic industrialisation by allocating resources away from export-goods production and toward production for the domestic market. High tariffs and tight quotas protected domestic industries from foreign competition. An overvalued exchange rate lowered the domestic price of imported capital goods for use in the domestic industrialisation process.

In the case of China, given the environment at that time, the development approach was also understood as industrialisation based on self-reliance, import substitution or state protection. Three factors contributed to the choice of an import substitution strategy. First, China adopted the “Soviet-style” economic model which was formed in Soviet Union under special conditions, due partially to the lack of experience in developing a socialist economy and partially to ideological identity. The feature of such a model was a closed-type development. Second, the severe economic blockade from foreign countries forced China to develop an economy depending on domestic resources and self-reliance. Finally, China faced a pressing task to industrialise its economy in order to improve the general standard of living. Given the low level of economic development at that time, it was easy to place the domestic market in the centre of development strategy. Like many developing countries, China chose an import substitution strategy as its way to industrialisation.

Under an IS regime, trade and other incentives are usually biased in favour of production for the domestic market and against production for exports. For a long time, China’s trade policies featured such bias. However, it was also the case that the increase of exports as a source of external payment was treated as an important policy target in China. Therefore, a policy dilemma exist: Export sectors were biased by an overvalued exchange rate on the one hand but export volume was targeted by administrative forces to be increased on the other. To compensate for the discrimination towards exports, China carried out a number of policies in the 1980s to strengthen export incentives. Imports were also

restrained by government controls. The general trade policy became one of encouraging exports while imports were strictly restrained (*Jiang Chu Xian Jin*).

Consequently, large amounts of government subsidies were provided for the expansion of exports. Many exports were in fact sold on a net loss basis. FTCs were not, however, responsible for the profits and losses of their export activities. While exports were forced to increase, imports were tightly controlled by the government through high tariffs, strict exchange controls and complex administrative procedures. All imports were assigned by the central government to support national economic development, since the economy was a unified and centrally-planned regime. The import strategy of the country was aimed at industrial development instead of direct improvement of the domestic consumer's market. That was why China's commodity composition of imports laid particular stress on producer goods (Import structure is to be analysed in subsection 3.2.2). The policy doctrine that "export is for import and import is dependent on the needs of domestic economic development" (*People's Daily* 1/12/1983) mandated China's foreign trade throughout the pre-reform period and even in the decades since reform.

### **3.1.2 Reconsidering Foreign Trade Strategy: Chinese Economists Debate**

Following the adoption of the reform and open-door policies, debate on China's foreign trade strategy was carried on amongst Chinese economists. Not surprisingly, different views on trade policy were reflected amongst Chinese economists.

#### ***Arguments***

(1) Shifting to Export Orientation A radical argument suggests that China's foreign trade strategy should be shifted from IS to export orientation (EO),<sup>[1]</sup> given that many of the tasks of import substitution have basically been completed in China. According to this argument, the use of the IS strategy in China was aimed at the domestic market and in favour of imports (imports of producer's goods were given a privileged position). It would cause the increase of imports and the decrease of exports. The consequence might be the shortage of foreign exchange and even a severe debt. On the other hand, the export orientation strategy could lead China's closed-type economy on to an open and outward-looking development track. The international market would be not only a supplement to the domestic economy but also a favourable environment for the country's development. All enterprises would have to improve product quality, production technology and operational

efficiency in order to compete with foreign producers in international markets as well as in an open domestic market. Exports would increase, and the situation of exchange shortage can be fundamentally released. Therefore, the export orientation strategy is an efficient way to solve the problem of exchange shortage that has been regarded as the bottleneck on the development of China's economy (Huang Fangyi 1985, 1986).

(2) *Remaining Import Substitution* The opposite opinion considers IS to be a long-term strategy for China's catching up with the industrialised countries. Several arguments are employed to support this strategic choice. First, a large country such as China has a huge domestic market which provides the precondition for implementing an IS strategy. Economic development should base upon the domestic economic circle, as most large countries in the world have done. Second, although China has implemented IS strategy for a long time, the task of import substitution is still hard. For example, between 1984 and 1985, imports of 20 largest manufactured goods accounted for about 50% of China's total manufactured goods imports. Third, China's major export sectors are labour-intensive industries and only operated for foreign exchange creation. No export industry can act as efficient leading sector to bring along the industrialisation in China. Finally, the lack of liberalisation in trade and capital flows, and the incomplete market system, are difficulties that prevent the implementation of an export orientation strategy (Liu Changli 1987).

Some Chinese economists have agreed that China should adopt a balanced foreign trade strategy which does not discriminate in favour of either IS or EP. However, given that China has a big economy with the characteristics of strong domestic demand and a low level of development, an EP strategy could not be an efficient way to promote the national economy. It also lacks the necessary base in physical terms to adopt such a strategy. Therefore, China's foreign trade strategy in the near future should have a preference for IS to complete the protected development of intermediate and capital products industries. IS strategy is the main way to develop the economies of less-developed countries (Tang Haiyan 1994; Liu Liqun 1994). This view actually treated a balanced trade strategy as a long-term target while IS was assumed to remain the priority of current trade policies.

(3) *Pursuing a Mixed Overall Strategy* Some Chinese economists think China should adopt a mixed trade strategy combining IS with EP. There are three ways of thinking about the implementation of a mixed foreign trade strategy. The first one is the "geographical

combination” of the two strategies. This argument believes that it is impossible to implement either EP or IS strategy throughout the country because of the different regional conditions. The nation’s aggregate strategy for development is to use both IS and EP simultaneously, on the basis of “mainly self-reliance with the assistance of foreign aid”. This strategy is workable to develop outward-looking economies in China’s coastal areas to promote the economic growth of the whole country (Wang Jizhu 1988).

The second way is the “sectoral combination” of the two strategies. This is to apply IS strategy to some “infant” or new industries while an EP strategy is implemented in the relatively mature industries. The traditional and mature industries should be encouraged to expand exports according to their comparative advantage. The increasing foreign exchange earnings, in turn, may powerfully support the development of the import substitution industries. The import-competing industries are expected to utilise introduced advanced technology to improve production structure and performance (Reng Jijun 1991). Some emphasise that the combination of the two strategies could establish a smooth economic circle linking the domestic and international economies. When the capital-intensive industries are modernised through import substitution, they will be turned into an export sector. Finally, the national economy may become outward-oriented (Cao Yuanzheng 1988).

The third way is the “aggregate integration” of the two strategies. Economists who hold this view think that neither IS nor EP could be the solely suitable strategy for China’s foreign trade development. Some pointed out that one of the measures for improving the mixed trade strategy is to encourage import substitution sectors to develop an outward-oriented ingredient, while the export-oriented sectors should import foreign advanced technology to improve their competitiveness. This implies a need to integrate the two strategies within each sector of the economy (Zhang Yangui and Xian Guomin 1987). The mixed strategy using these two ingredients also should not be limited by assigning regional or industrial ranges. It is better to integrate IS and EP in every region or industry, together with a necessary adjustment from time to time (Huang Jingbo 1989).

### ***Right Choice for China: Coexisted or Integrated trade Strategy?***

What could be the right trade strategy for China’s ongoing reform economy? The above mentioned arguments need to be evaluated. In the author’s opinion, China’s trade strategy

should be a mixed strategy integrating IS in selected sectors with the ingredients of an overall EP. Three aspects need to be further discussed as follows.

First, it is right that neither IS nor EP alone could be the right trade strategy for China. Arguments for a single strategy of IS or EP have in fact over-simplified the complexity of China's economic structure and the variety of tasks in developing different industries. Further, concerning the experience of these strategies, neo-classical economists have proven that the IS strategy is inefficient as a way to development and the EP strategy is a much better choice for the developing world. The experience of the IS strategy in China has also been problematic. The question now is whether the EP strategy alone is suitable for a large developing country like China. So far, the successful stories of EP strategy have all been relative to small economies. In a large country, a huge domestic demand could permit economies of scale even in the absence of export markets (Yoshitomi 1996). Of course this should not be a reason for rejecting the opening-up of an economy. But it implies that trade strategies in countries with different sizes of the economy could be varied. China is a developing country with typical feature of "dual structure" a coexistence of traditional labour-intensive industries and relatively advanced capital- and technology-intensive industries. China's comparative advantage lies in its low labour cost. Using an EP strategy to maximise the benefits of such an outward-oriented strategy is therefore appropriated for the traditional industries. But the shock of stronger foreign competition under the EP strategy might result in an unfavourable environment for the development of the industries which have not yet become internationally competitive. Even if some protection measures were allowed for those "infant" industries, as permitted by neo-classical economics, the EP strategy could not be *dominant* in China, since so many industries are "less-developed".

Second, mixed strategy is common in most developing countries. More important, a mixed trade strategy could fit China's special economic conditions. The emergency of the EP strategy has most significance in providing an alternative way to development, but it is by no means a replacement for the IS strategy. The superiority of the EP strategy does not preclude the use of IS strategy in selected industries (Bhagwati 1988a). In fact, combinations of the IS and EP strategies can be found in most developing countries, due to the fact that they are largely complementary (Dijk 1990). For developing countries where conditions are suitable, it may be ideal to change the trade strategy from IS to EP as the successful Asian economies have done, using the EP strategy to accelerate economic development. The

conditions for such a strategy transition, among others, include a right moment for policy changes, the availability of export markets, the presence of leading export sector(s) and the possibility of better performance under the new strategy. An alternative would be a mixed strategy in which elements of IS and EP strategies co-exist. In the case of China, apart from its special economic structure for which the EP alone is not a practicable strategy, the absence of a leading export sector(s) and a market mechanism linking the various sectors may produce uncertain results for an EP strategy. On the other hand, given the long-lasting and less efficient practice of the IS strategy in China, it is important to develop the ingredients of the EP strategy in response to the opening-up of the economy. In this sense, China's trade strategy is likely to be a mixed one.

Third, it is not enough to put the two strategies together to form a simple strategy mixture. Instead, it is necessary to integrate the ingredients of the IS strategy with those of the EP. If both IS and EP strategies exist independently rather than being integrated, not only might they benefit less from each other but also may their positive policy effects be offset. For example, import restrictions under an IS strategy will also distort the neutral structure of incentives pursued by the EP strategy.

It is important, when integrating these two strategies, to combine the market mechanisms and government interventions appropriately, so as to ensure effective co-ordination between the targets and policies pursued by each strategy. Nevertheless, the crucial side is the role of government intervention. Market information can signal the extent that a strategy has been achieved and the need for policy change but cannot automatically switch the trade strategy from one to another. By contrast, government activity seems more aggressive than market forces. Not only can government intervention advocate a trade strategy change, but also may it be important to make a strategy work successfully. This was the case in regard with the practice of the EP strategy in most East Asian economies (Bhagwati 1988a). The further question here is whether government intervention can also act appropriately in controlling the use of IS strategy. Theoretically, such a possibility is not unattainable. On the assumption that government can be self-constrained, neo-classical economics allows government to play a role in resource allocation and, to some extent, in supporting "infant industry". In practice, some East Asian economies, such as Korea and Taiwan, have skilfully used government forces to control the process of import substitution and then changed their strategies to the EP. The failure of trade strategy change in the



majority of developing countries reflects a failure to judge and control the process of import substitution, not a total failure of the IS strategy itself. No one has persuasively demonstrated that the IS strategy should necessarily be excluded from the strategies for the developing world!

Based on the above discussion, the integration of the two strategies requires a changeable policy system in which all policies must be compatible, or, at least possible policy trade-offs are kept to a minimum. In particular, in the case of China for example, the following principles should be considered essential for an integrated overall trade strategy. First of all, the IS strategy is to be used only in some strictly selected sectors, essentially the technology-intensive industries, and the sectors selected for import substitution should be changeable according to the dynamics of the economy; Second, the period of implementation of the IS strategy should be as short as possible to avoid the negative effects of long-lasting protection; Third, the degree of protection for IS sectors should be decreased as these sectors begin to grow. Fourth, the EP strategy would be initially used as the first step in moving toward neutrality, balancing the incentives for both IS and EP sectors. With the limited protections for IS sectors and stronger incentives for EP sectors, the overall trade strategy might reach a point of neutrality. Finally, by taking parallel reductions of excessive export incentives and import protections the trade regime could become liberalised.

### **3.1.3 Trade Strategy Changes in China**

As mentioned above, the emphasis on “self-reliance” has led to a long-lasting practice of import substitution in China. The adoption of the open policy at the end of the 1970s was not an attempt to phase out this strategy but divided it into two stages (Huang Jingbo 1989). The differences in import substitution in these two stages were as follows: First, the economic conditions for the implementation of import substitution varied in the different periods. There was a highly closed regime before 1978 but an increasingly open economic system emerged thereafter. Second, import substitution under a relatively open economy led to a reduction of administrative intervention and an increasing use of market levers in directing the process of economic development. Import substitution before 1978 was basically dependent on non-economic forces in the forms of central command plans, administrative organisation and political demand. Since reform, market forces have been allowed to play an important role in the process of import substitution. Domestic demand

has become a decisive factor in developing industrial structure. It is evident that the Chinese government has stopped making import-substitution plans (lists), so as to reduce direct administrative intervention in foreign trade. Third, while the various benefits from opening-up the economy have been enjoyed, import substitution has no longer been considered the only way toward industrialisation. In contrast, the launch of the reform and open-door policy began the process of changing China's economy from self-reliance to an open economy. Strategies for export-oriented growth and market competition with appropriate government intervention have attracted much attention from central and local government leaders and business circles. China's trade strategy has in fact turned into a mixed package combining the ingredients of import substitution and export promotion.

However, the shift in trade strategy was not a straight move from IS to EP. The initial attempt of the reform was to modify the planned economic system to improve efficiency, without fundamental changes in the management regime. The reforms of the foreign trade sector in the early stages concentrated on the adjustment of management authority between central and local governments and on the moderate adjustment of some export and import policies. Several export incentive instruments including the foreign exchange retention system, export subsidies and devaluation become important balancing factors against the anti-export bias while the import substitution strategy remained as general policy for foreign trade until the late 1980s.

The most important turn in China's trade strategy has occurred in the 1990s. Besides the elimination of export subsidies and the exchange retention system, import barriers such as tariff rates and non-tariff barriers have been substantially reduced. This shows that China is moving to freer trade through reducing the incentives for both exports and imports.

## **3.2 EFFECTS OF IMPORT SUBSTITUTION**

### **3.2.1 The Literature**

As a way to development, IS strategy was common in the developing world in the post-war period. But the effect of this strategy was mixed. There are two points to be raised concerning these mixed results. The first is that the IS strategy may bring about both benefit and damage, depending on the specific situation in each country. Krueger (1978) pointed out that both import substitution and export promotion increase capacity utilisation but such an effect under EP strategy is greater than that of IS strategy (pp. 181-182). Whilst it could not

be ignored that the IS strategy led to fast growth, at least for a short period in the beginning, the implementation of this strategy also resulted in distortions that reduced efficiency and productivity growth (Syrquin 1994). The second is the variety of experience in different countries. Many countries followed an industrialisation process entirely dependent on IS strategy and, therefore, suffered from the damage caused by the protectionist policies associated with this strategy. In the post-war period, however, a few countries (mainly the Asian economies) were successful in import substitution and promptly turned to an outward orientation. They have enjoyed the benefit of the IS strategy. This suggests that the implementation of the IS strategy is not one without any merit, despite the commonly accepted view that it is an inappropriate strategy for long-term development in the developing world, especially when compared to the export promotion strategy.

At least two achievements of the IS strategy can be mentioned, accepting the possible costs of protection. (1) The IS strategy can achieve some substitutions. In some countries, import shares in total supply declined after a period of import substitution (for example, see Little *et al.* 1970, p. 60, for the cases of Pakistan, Philippines, Brazil, India and Mexico). This significantly relaxed the pressure on foreign exchange. Relatively, exports for foreign exchange earning could be slowed down in order to concentrate on production for the domestic markets, or to the end, on industrialisation. (2) An import substitution strategy can stimulate industrialisation of the domestic economy in the initial stage of development. A set of industries may be created as a basis for further development, as well as the foundation for strategy shift to outward-orientation in some countries. Chenery (1980) pointed out that IS was an important and necessary feature of the early stage of industrialisation in the NICs. In the way that IS strategy implies protective policies, there is another argument worth to be mentioned here. Senghaas (1985) argued that much of the early European experience involved selectively controlled trade and protective policies for promoting infant industries.

Starting by the study of Little *et al.* (1970), and especially after the Bhagwati-Krueger studies (Bhagwati 1978; Krueger 1978), there was a growing body of literature demonstrating the limitations of the IS strategy and the advantages of the EP strategy.<sup>[2]</sup> Some major shortcomings of the IS strategy described in the literature include: (1) High level of effective protection induced overvaluation of the domestic currency, price distortion and bias against exports, resulting in resource misallocation divorced from the principle of comparative advantage; (2) Domestic production highly dependent on imports of equipment

and raw materials which, in turn, left the problem of foreign exchange shortage unresolved. (3) The exclusion of foreign competition discouraged innovation, cost-cutting and the enhancement of technological capacities, resulting in inefficient production or low-capacity utilisation; (4) Excessive administrative intervention over trade led to an even higher cost of protection.

These consequences were relative to the key policy features of the IS strategy high tariff rates, strict import quotas and the over-valued exchange rate(s), and the institutional settings associated with these policies. The imposition of tariffs and import quotas reduced the demand for foreign exchange. But this induced an appreciation of the domestic currency which increased the export costs and made imports cheaper. While import barriers remained high for consumer goods but relatively low for intermediate goods, resources would be directed to import-competing sectors. Being inward-looking, the IS strategy was initially intended to reduce external trade because the ideological belief of self-reliance undermined the role of foreign trade in development. However, import substitution could be a long process, in the sense that newly expanded industries lacked an appropriate technological basis to rationalise the production. When import substitution industries grew up, related imports of capital goods would increase as well (Krueger 1995, pp. 8-11). For the payment for imports, exports would be pushed to expand on a larger scale.

Moreover, the anti-export and anti-competition policies of the IS strategy protected the import-competing industries to be operated at low productivity, due to the absence of competition in the domestic and foreign markets which forced enterprises to improve their operation. As result, after its “once-over” stimulation at the early stage if any, the IS strategy could not induce a sustained growth of the economy.

### **3.2.2 Effects of China’s Import Substitution**

China’s experience of import substitution followed the above description. Meanwhile, the adoption of the export promotion strategy in the 1980s also generated significant effects on trade policy reform which distinguished China from many other countries. This section discusses the effects of the IS strategy in China, considering IS policies as existing environment. The concrete measures of trade policy reform are examined in the following chapters.

### ***Industrialisation and Import Substitution***

Continuous introduction of foreign equipment and technologies (from former Soviet Union in the 1950s, and from various sources since the 1970s) enhanced China's industrial capacity. A unified, nation-wide and multi-layer industrial system was built up. Regarding economic growth, China also enjoyed a fast growth rate in most years. In 1953-1978, China's average annual growth rate of GNP was 6.1%. From 1979 to 1997, China registered an average annual rate of GDP growth of 9.9%. The average annual growth rate of gross industrial output value in 1980-1996 was 15.8%, while this rate was 11.3% in the period of 1953-1980. This rapid economic and industrial growth could not be excluded from the achievements of the country's industrialisation process although this process was heavily dependent on very high rate of inputs, implying a relatively low efficiency of resource allocation.

In the drive for substituting imports with the introduction of foreign technology and equipment into the industries to increase their capacity, some products have achieved their desired goal. TV sets and synthetic fibres are examples of success. Table 3.1 shows the effects of import substitution in various industrial products. Of the eight comparable products in this table, in the year of 1985 when imports surged with the relaxation of import controls, the ratios of import to total supply of six products increased. Only TV sets and synthetic fibres supplies have reduced their dependencies on imports. During 1985-1995, compared with the level of 1985, five out of the eight products increased the proportion of substitution. However, in the whole period from 1980 to 1995, the ratio of imports to total supply kept going up in metal-cutting machines and pesticides, together with that rolled steel and chemical fertilisers recorded larger rate of dependence on imports.

**Table 3.1** *Share of Imports in Total Supplies (SITS)\** (%)

	SITS			Percentage change		
	1980	1985	1995	1980-1985	1985-1995	1980-1995
Rolled steel	12.0	35.2	14.8	23.2	-20.4	2.8
Motor vehicles	19.5	44.7	9.8	25.2	-34.9	-9.7
Metal-cutting machines	1.9	7.2	25.4	5.3	18.2	23.5
Synthetic fibres	44.3	38.9	28.2	-5.4	-10.7	-16.1
Paper & paperboard	n.a.	9.2	n.a.	-	-	-
Polyethylene in primary forms	n.a.	53.2	n.a.	-	-	-
Pesticides	2.4	7.1	25.4	4.7	18.3	23.0
Chemical fertilisers	30.6	36.5	42.8	5.9	6.3	12.2
Soda ash	16.1	34.5	1.2	18.4	-33.3	-14.9
TV sets	49.6	23.4	3.2	-26.2	-20.2	-46.4

\* SITS =  $VOI / (VOI + VOD)$ , where VOI = volume of imports; VOD = volume of domestic output.

Source: State Statistical Bureau (1992); State Statistical Bureau (1996b);

### *Structure of Imports*

China's industrialisation followed the typical route to import substitution. That is, a country increases domestic production by the means of introducing foreign capital goods (equipment and raw materials) to strengthen its capacity of output and to replace those it has previously had to import. China's commodity composition of foreign trade reflected such a spirit of import substitution strategy.

In China, before the reform, over 90% of total imports in the 1950s were production facilities. In the remaining years until the late 1970s this proportion remained above 75%, except the first half of 1960s when China suffered from supply shortage resulting from natural calamities (Table 3.2-a). Most imports were raw materials, agricultural products, and machinery and equipment.

**Table 3.2-a China's Import Structure in Pre-reform Period, Selected Years (%)**

	1950	1953	1955	1960	1965	1970	1975	1978	1980
Imports of production facilities	83.5	92.1	93.8	95.4	66.5	82.7	85.4	81.4	78.9
Imports of consumer goods	16.6	7.9	6.2	4.6	33.5	17.3	14.6	18.6	21.1

Source: State Statistical Bureau (1981), p. 358.

**Table 3.2-b China's Import Structure, 1980-1996 (%)**

	1980	1985	1990	1995	1996
Primary goods	34.8	12.5	18.5	18.5	18.3
Manufactured goods	65.2	87.5	81.5	81.5	81.7
Machinery & transport equipment	25.6	38.4	31.6	39.9	39.4

Source: State Statistical Bureau (1996b, 1997b).

The preference of production facility imports over others continued in the 1980s and 1990s. One important target of China's open-door policy is to improve its industrial capacity by introducing foreign advanced equipment and technology. Most imports of equipment and raw materials have enjoyed preferential treatment of tariff reduction or exemption. In 1995, for example, about 80% of machinery and electrical product imports were given preferential treatment of tariff reduction or exemption. In the structure of imports, equipment and raw materials remained the main type of import.<sup>[3]</sup> Because China changed its statistical method, adopting the SITC in 1980 and then HS since 1992, the accurate data classified as in Table 3.2-a are no longer published. However, it is possible to obtain a rough estimate based on official data. The estimated results show that the share of

equipment and raw materials in total imports since the mid-1980s has remained within the range of 70-85%,<sup>[4]</sup> very close to the level before reform. Given the fact that trade barriers for imports of consumer goods remained high, although several significant reductions did take place in the 1990s, China's such a structure of imports demonstrated the features of an import substitution strategy in the reform period.

### ***"Compulsory Export"***

For a long time, the view that the central task of foreign trade was to increase foreign-exchange earnings through exports has been the doctrine which strongly influenced the makings of trade policy in China (Shi Shijun 1995, 1996). The initiative of this doctrine probably related to the fact that export earnings were the main resource to pay for imports. Because of the low level of the economic development, many industries were regarded as "infant industries" to be developed under import substitution protection. Demand of import was extremely high. This led to, as analysed, an import structure biased in favour of production facilities. It was reported that, during the period of 1979-89, more than 80% of foreign exchange for the imports of necessary raw materials, equipment and technology came from export earnings (*China's Foreign Trade*, Nos. 10-11, 1989, pp. 3-4). This ratio could be necessarily higher in the pre-reform period because the other resources for financing imports, such as the gains from overseas investment and the exchange earning through service exports, were very small. Export expansion, therefore, became the priority in the development of China's foreign trade.

The special position of exports in the Chinese economy produced a "compulsory export" model of foreign trade. The features of "compulsory export" were as follows: Initially the requirement of planned economic growth determines the scale of imports. Then, the scale of exports is accordingly decided by the scale of imports (Wang Dongjing 1994). Because China has long been pursuing a rapid development programme, the expansion of economic size generated increasing demand for imports. In turn, this trend of import growth forced the further expansion of exports. However, the size of exports could not exceed the possibility determined by the development level of the economy. China faced the question of foreign exchange shortage like many other developing countries. Insufficient capacity of payment could not afford for the growing imports. Therefore, government policies had to restrict imports on the one hand, and to expand exports through creating export incentives for FTCs on the other.

The “compulsory export” policy pushed China’s exports to grow. Exports increased at an average annual rate of 16.68% between 1979 and 1997. However, the growth of exports was not a response to an increase of export prices although export price index increased, for example, from 73.3 in 1978 to 120.9 in 1993.<sup>[5]</sup> Lardy (1994) rightly pointed out the deterioration in terms of trade was due to rising prices paid for imports (Lardy 1994, p. 40). During 1978-1993, as shown in Table 3.3, the import price index increased by about 52 percentage points while export price index only had a 48 percentage points increase. The terms of trade declined from 115.4 in 1980 (121.4 in 1982) to 101.1 in 1993. Because of the rapid expansion of the economy, import demand was always strong and the actual imports grew fast. Increasing imports, in turn, forced exports to be further expanded regardless of the deteriorating trend in terms of trade.<sup>[6]</sup>

**Table 3.3 Terms of Trade, 1973-95**

(1987=100)

	1973	1975	1978	1980	1985	1987	1990	1991	1992	1993	1994	1995
<b>Export price index</b>	59.2	61.2	73.3	102.5	87.9	100.0	120.9	122.0	123.1	120.9	n.a.	n.a.
<b>Import price index</b>	48.8	56.6	67.8	88.8	80.4	100.0	114.5	116.5	121.7	119.6	n.a.	n.a.
<b>Terms of trade</b>	121.3	108.1	108.1	115.4	109.3	100.0	105.6	104.7	101.2	101.1	105.0	105.0

Source: World Bank (1995b, pp.210-211; 1996; 1997b).

Of course, changes in terms of trade, either increasing or decreasing, are normal phenomenon in world trade. But in most case the decline in terms of trade could, and should, not stimulate export expansion unless the foreign exchange earnings are absolute needed. However, China’s export expansion accompanying the decline in terms of trade was just aiming at the increase of foreign exchange earnings. The use of the “compulsory export” policy in this case was not therefore surprising.

Rapid export expansion enabled China to alleviate the foreign exchange shortage. Despite a great amount of foreign exchange, used to feed the increasing demand of imports, China’s foreign exchange reserves still increased from US\$0.167 billion in 1978 to US\$139.9 billion in 1997 (Li Peng 1998). Whether China needs to have such a large foreign exchange reserves is not the theme of this study. However, if the increase of export earning was just for the government’s holding of foreign exchange reserves, the excessive export expansion became insignificant and harmful for the development of foreign trade. Export expansion is worth encouraging because export earning can be a source for improving the



domestic production or national welfare. Holding too much foreign exchange shows nothing but a fact of resource wastage.

In fact, some more problems can be found behind the fast growth of exports. The “compulsory export” policy led to a situation in which enterprises and sectors focused on the increase of export volume (quantity) while ignoring the improvement of effectiveness. The quantitative expansion of exports was largely attributed to the following reasons: First, there was a strong demand for imports since China has been seeking to enhance the level of industrialisation. Increasing requirements of foreign exchange to pay for the imports of production equipment and materials put a heavy pressure on exports to be expanded. Due to the low competitiveness of Chinese products in the world market, a very important means of increasing foreign exchange earnings was to increase the volume of exports regardless of the price decline.

Second, it seemed that China’s comparative advantage was in labour-intensive exports for which there was a relatively large market in developed countries. This situation encouraged the fast growth of China’s labour-intensive exports. China has abundant labour resources but a relatively low level of natural resources per head in the world (Xiao Zhuoji *et al.* 1992, pp. 36-37).<sup>[7]</sup> Logically, what China needed was to change the export structure by reducing the proportion of resource-intensive products and increasing the share of manufactures with higher capital and technological ingredients. However, the excessive emphasis on foreign exchange earnings, naturally, led to the enhancement of industrial and export structure being ignored. Although the exports of some manufactured products have rapidly increased since the second half of the 1980s, the low value-added nature of these exported commodities has not fundamentally changed.

Third, some institutional imperfections also strengthened the trend of quantitative expansion. Most FTCs could not fully, and independently, determine their own business. FTCs had to follow government supervision rather than reacting to market signals. Under the regime of the contract responsibility system during 1988-91, for example, the amount of foreign exchange earnings was one of the main indicators for evaluating the operation of FTCs. As a result, FTCs had to achieve the target of making exchange earnings by expanding exports regardless of efficiency. In addition, the targets for FTCs to increase the volume of exports also induced blind competition among enterprises, areas and even

provinces. One result of blind competition was the decline of export prices. Once export prices had declined, more exports were needed to make up the same exchange earnings.

Finally, the most important factor stimulating the simple quantitative expansion of exports was the implementation of trade policy. A powerful instrument used before 1994 was the foreign exchange retention system. The proportion of foreign exchange which could be retained by an enterprise depended on its export performance, as well as its status and location. If an enterprise overfilled the assigned export target, the extra earning of foreign exchange could be shared by the enterprise on a higher ratio. In some areas, the retention shares for assigned export earnings were such that 80% went to central government and 20% to the enterprise itself, but the ratios for overfilled earnings were 20% and 80% respectively (Cai Jimin 1995). The more exports, the larger the amount of foreign exchange that could be retained. Another policy instrument was the duty drawback system implemented since 1985. The aim of this policy was to balance tax burdens between exports and imports and to strengthen the competitiveness of export products. The implementation of this duty drawback policy seemed helpful in promoting China's exports since the tax rebate became an important source of funds that enabled enterprises to reduce export prices. In addition, the frequent devaluation of the *Renminbi* since the mid-1980s also provided stimulation for export growth. The devaluation of *Renminbi* meant that exports could be further expanded through price decreases. The exchange rate changed from 2.8 *Renminbi* per dollar in 1984 to 8.7 *Renminbi* per dollar in 1994. Although some (e.g. Pei Ping 1994) argued that the devaluation of *Renminbi* had little effect in promoting export growth, the exchange rate reform could not be regarded as meaningless for exports. At a minimum, it has contributed to maintaining the high growth of exports. In 1994, China's export growth rate was 31.9%, much higher than a 15% average annual growth rate in the previous reform years since the late 1970s. This supernormal growth rate seemed, in a large part, due to the unification of the exchange rate system and the accompanying drastic devaluation of *Renminbi* in 1994 (Zhong Pengrong 1996). However, in the sense that the exchange rate mechanism in China still lacked a solid foundation in the market economy, devaluation and exchange rate adjustments did not fully function as stimulators for export expansion. Therefore, the function of exchange rate system in promoting exports in the past reform years should not be overestimated. Trade flows will not change with fluctuations of

the exchange rate if exporters and importers cannot respond to the change of price signals caused by devaluation or revaluation.

### *Efficiency*

The term of economic efficiency can be understood in two specific aspects -- allocative efficiency and technical efficiency. *Allocative efficiency* refers to a situation in which resources (factors of production) are allocated to those sectors where the maximum output will be produced. *Technical efficiency* refers to a situation in which the best technology is employed, which means factors of production are optimally combined, to produce output at lower cost or of higher quality.

Under an import substitution regime, China conducted a series of development policies aiming at centralising economic power, emphasising heavy industries and pursuing a high speed of growth. Among these policies, a high accumulation rate stimulated huge government investment in support of the import substitution of heavy industries. Li Jingwen (1993) in his empirical study pointed out that China's rapid growth in 1952-1979 was a low-efficiency growth supported by high input rate, at the cost of low improvement to people's living standards. At the same time, efficiency in terms of output per unit of capital was also low because of poor management and the lack of incentives. In the pre-reform period, the ratio of investment to national income was above 1.9:1, meaning that for every unit of national income increase in terms of *Yuan* it needed to increase capital inputs by 1.9 *Yuan* (Song Guangmao 1996).

Since reform, this situation has not fundamentally changed, it may even have worsened. The profit-capital ratio in state-owned industries has declined and the total loss of state-owned enterprises has expanded (Table 3.4).

**Table 3.4 Efficiency of State-Owned Industrial Enterprises** (%; billion of *Yuan*)

Year	Pre-tax profits / total capital	Profits / assets	Proportion of loss-making enterprises in all enterprises	Total loss of loss-making enterprises
1978				4.21
1980	24.94	16.00		3.43
1985	23.80	13.20	9.6	3.24
1990	12.40	2.60	27.6	34.88
1995	8.01	1.85	33.5	63.96
1996	6.54	0.99	37.7	79.07

Source: State Statistical Bureau (1996b, 1997a; 1997b); Mao Tianqi (1997a, 1997b).

As can be seen, the total loss of state-owned industrial enterprises has increased sharply since the beginning of the 1990s. The competitiveness of state-owned enterprises became relatively weak, especially in contrast to the emergence of the rural and township economies. State-owned enterprise reform stagnated, owing to the poorly-defined property rights, an incomplete market system and excessive administrative intervention. Their operational characteristics, formed under the earlier import substitution regime, such as depending on government investment, seeking protection and expecting preferential policies, have not yet been changed. Regarding government policies, market-type reforms have not been carried out until recent years. High tariffs, a high exchange rate and strict import controls maintained an environment fitting import substitution as it was. When trade policy reforms started in the 1990s, state-owned enterprises found their situation was so severe that they could not avoid heavy losses.

With regard to China's import substitution, there are some points to be noted: First, it is difficult to assess whether the import substitution policy in China has been successful or if it has failed. Both benefits and costs have been brought out by implementing this strategy. Second, China's import substitution lacks the foundation of a complete market system. When import controls were released, for example in 1984 and 1993, imports almost immediately surged. This reflects the fact that import demand was restrained other than being met by domestic substitutes. Finally, China's import substitution was still at a stage concentrating on the substitution of ordinary products. Many products with higher technological ingredients, such as complete sets of equipment, medical instruments and appliances, and communication equipment, were highly dependent on imports. In this sense, China's import substitution was far from complete.

### **3.3 EVALUATING CHINA'S EXPERIENCE OF TRADE STRATEGY CHANGES**

#### **3.3.1 Classifying China's Trade Strategy**

Conventionally trade strategies have been divided into IS and EP. However, the possibility of their coexistence has opened a large space in which the mixture of the IS and EP strategies may be varied. Liang *et al.* (1991) developed a new classification of trade strategy by adding two concepts to the conventional method. Besides IS and EP, there are two strategies to be considered. One is "protected export promotion" (PEP) referring to "promoting import substitution for the sake of developing new exports". Another is "*de*

*facto* import promotion” (DIP) which “minimises exports and maximises imports, intentionally or unintentionally, in order to provide the needed resources and incentives for domestic investment and consumption”. According to their analysis, some of the East Asian economies such as Korea and Taiwan are found to have pursued a PEP strategy rather than a pure EP strategy. By contrast, the incentive structure of DIP characterises an insatiable “import hunger” and systemic bias against exports.

It is interesting to note that there are two quite different assessments over China’s trade strategy in two World Bank studies, both have obviously adopted the above classification of trade strategy. In an earlier study, China’s foreign trade regime was thought of as a DIP regime, although China’s intention was to pursue the PEP strategy as its Asian neighbours did before (World Bank 1994a, pp. 80-81). More recently, in the *World Development Report 1996*, China’s trade policies were described as those which “have combined substantial, although partial, liberalisation with active export promotion” (World Bank 1996, p. 29). In other words, China’s trade strategy is established as a kind of PEP. Why have these two studies had so different conclusions?

The reason seems largely due to the significant change of China’s trade policies at the time. Over the past 20 years both export and import policies were frequently adjusted. In particular, around the period of 1992-1996, the time those two World Bank studies were published, China conducted its intensive trade policy reforms in the clear direction of trade liberalisation. Given the pace of change of China’s trade policy, it is difficult to identify the real trend in trade strategy.

Looking back, however, China’s newly adopted trade strategy could not be regarded as either a pure DIP or PEP. As mentioned above, the rapid growth of the East Asian economies were an important element in determining China’s reform and open-door policy. Many new trade policy measures were carried out with an intention of pursuing the effect of PEP. It was evident that in the 1980s, when most import barriers were not liberalised, a series of export promotion measures including the enhancement of purchasing prices for export goods, the set-up of exchange retention rates, the decentralisation of export rights, and devaluation of the domestic currency were the main episodes of China’s trade reform. In addition, imports were tightly controlled except those needed for export production.

China's exports increased rapidly in the 1980s. Such a strategy is similar to that of some Asian economies in the 1970s, where it was attested an effective strategy. However, China's trade policy reform is in a very different situation from that of her Asian neighbours in the 1960s and the early 1970s when the linkages between export promotion and import protection or liberalisation seemed not to be as tight as it has been since the late 1970s. Since the 1980s, especially since the Uruguay Round, every country has become more sensitive to their counterparts' trade policies. Given that China has been making great effort to re-join the GATT and enter the WTO, the pressure of trade liberalisation forced China to accelerate the pace of trade policy reform. This has meant that China, unlike some East Asian economies, has had to carry out liberalisation reforms in exports and imports simultaneously. Therefore, although the PEP strategy describes the strategy in China during the 1980s, since the 1990s, China in fact has not been able to maintain a pure PEP strategy and take the advantage of "promoting export without import liberalisation" like some of her East Asian counterparts.

Can China's trade strategy be thought of a typical DIP strategy? It is true that China's import demand was strong. The actual imports increased rapidly, with an annual growth rate of 14.49% during 1979-1997. In the first half of the 1990s, the annual growth rate of imports (19.9%) was even higher than that of exports (19.1%). However, this is by no means proof that imports were encouraged. Three reasons can be considered supportive to such a conclusion.

First, China's rapid growth of imports was based on the support of high growth rate of exports. During 1980-1989, China had a total trade deficit of US\$44.986 billion, due for a large part to "import hunger" released in this period. From 1990 to 1996, a total trade surplus of US\$46.616 billion was enjoyed while import restrictions were much reduced. This phenomenon, together with China's huge foreign exchange reservation, showed that imports have not been the priority of the trade strategy.

Second, using imports as a means to production resources is a feature shared by both the DIP and IS strategies. But treating imports as a source for domestic consumption distinguishes the DIP from the IS strategy. From the earlier analysis of China's import structure, it can be seen that the import of consumer goods has not been encouraged

although the improvement in living standards might suggest that such an increase in demand for imported consumer goods has occurred.

Third, most importantly, it must be considered whether the incentives provided to importers exceeded those to exporters. A widely used method for classifying trade strategies is to calculate the effective exchange rates (EERs) to show the trade regime “bias”. The effective exchange rate on exports ( $EER_x$ ) or on imports ( $EER_m$ ) is defined as the units of domestic currency actually paid or received for a unit of foreign exchange. In 1994, China’s “average domestic cost of foreign exchange” (can be considered as approximate  $EER_x$ ) was 8.65 while  $EER_m$  was 8.99.<sup>[8]</sup> According to Bhagwati’s definitions (1988a), China’s overall trade strategy in 1994 could be classified as an EP (neutral) strategy since the ratio  $EER_m/EER_x = 1.0393$ , fitting the requirement of neutrality where  $EER_x \approx EER_m$ . In addition, based on the author’s constructed EERs, the trade bias ratios were also close to unity from the mid-1980s (see Appendix Table 1). This suggests that, although China’s overall trade strategy in the 1980s could be thought as an attempt of PEP to correct the anti-export bias of the IS strategy, the incentive structure in China has now moved to a neutral situation with less bias. Imports, in this case, have not been encouraged.

Interestingly, based on the author’s constructed EERs, China’s trade bias ratios in most years of the reform period were not severely deviant from neutrality. However, that is not to say that China adopted free trade policies in the early years of reform. On the contrary, China’s trade policies before the 1990s were far from free trade. The existence of the IS strategy in the 1980s, with an over-valued exchange rate, high tariffs and strict import quotas, resulted in certain anti-export bias. On the other hand, the continuous effort to create export incentives in the same period showed China’s attempt to aggressively participate in the world market and, strategically, to off-set the effect of anti-export bias of the IS strategy. In balance, trade policy was turning to a mixture of IS and EP, or specifically, a combination of the DIP and PEP. The trade bias ratio in the 1980s reached a level of neutrality with strong export promotion and high import protection. In the 1990s, both import restrictions and export incentives have been significantly reduced. The neutrality of the trade regime was achieved with less preference towards either exports or imports. This plausible change in trade policy demonstrated that China’s trade strategy has

shifted from an aggressive participation in international markets to an indiscriminate integration with the world economy.

### **3.3.2 Evaluating China's Trade Strategy**

Based on the above analysis, it is possible to conclude that China's trade strategy was derived first from the IS strategy before moving to the Ultra-EP (or EO) strategy and then, through intensive trade policy reforms, to a mixed strategy — EP strategy in terms of neutrality. The shift of trade strategy has been a foundation for further liberalisation of trade policies. However, China's trade strategy shift has not been without problems.

First, China's trade policy reform was not a straight move to liberalisation. The possibility that of combining export promotion with import protection has enabled China to carry out its gradual, partial trade reform. The beginning of trade reform can be thought of as the initial attempt to allow exports to play a more important role in directing economic and foreign trade development. Since then and throughout the 1980s, a main line of trade reform has been the promotion of export growth through the strengthening export incentives. Although sustained export growth in the 1980s encouraged China to let more and more areas open-up, trade reform was slow and partial. The only significant trade policy reform in the 1980s was the limited devolution of trading rights. Import substitution policies were maintained almost unchanged. Less progress had been made in reducing trade protection. The intensive trade policy reforms in the 1990s seem a significant effort to implement a balanced trade strategy. However, China still lacks the solid foundations to ensure she reaps the benefits of these trade policy reforms. Some crucial obstacles still remain. One is that a well-functioning market economy has not yet been established. Another is that government administrative controls continue to play an important role in China's foreign trade. In this context, the effects of trade policy reforms may be offset by the incompleteness of trade regime reform.

Second, the two ingredients of trade strategy, import substitution and export promotion, coexisted rather than co-acted. Although export promotion supported import substitution to some extent, dynamic linkages between export promotion and import substitution have not yet been built up. Thus improvement have been seen both in effective substitution of some products and in the fact that manufactures increased to over 80% of total exports. However,



almost all of these successes occurred in the areas relating to low-technology and labour-intensive products. The goal that combines export promotion and import substitution to upgrading the industrial structure has not been achieved successfully.

Third, China lacks a complete set of trade policies to harmonise export promotion and import substitution. Enterprises cannot get sufficient market signals to determine their market goals. Even in the 1990s, when some intensive trade policy reforms have been conducted, it is unlikely that enterprises could respond well to the trade policy changes. In addition, China has claimed it plans to establish a free trade system. An essential requirement is to remove all barriers to trade and establish a neutral incentive mechanism without any discrimination toward exports or imports. This means a further and more difficult reform of trade policies is still required in China.

In this chapter, China's trade strategy has been examined, as indicating the general direction of trade policy in the country. The significant contribution made in this analysis is the explanation of the way in which China's trade strategy has been rightly shifted from aggressive participation in international markets to an indiscriminate integration with the world economy. It is the author's own view that China has been moving in the direction of a mixed, balanced and neutral trade strategy. While the IS policies remained in the 1980s, the creation of export incentives offset the anti-export bias of the IS strategy and enabled China to attain a neutral trade regime or balanced trade policy system, featuring a combination of DIP and PEP. By reducing export incentives and import restrictions in the 1990s, China's trade strategy reached a new level of neutrality with less preference towards either exports or imports.

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<sup>[1]</sup> Strictly, a moderate distinction should be made between export orientation (EO) and export promotion (EP). EO refers to a strategy which is in favour of exports and expects an export-led (EL) growth, very close to the term Ultra-EP, while EP is understood a neutral strategy as used in the existing literature. However, in a simplified way, all these concepts can be treated as the opposite of import substitution (IS) strategy. Given the fact that many Chinese economists have not made strict distinction between EP and EO or EL or Ultra-EP, it is difficult to classify whether their views are EO or EP. It should be aware that the term EP used in this chapter, where concerns Chinese economists' views, may contain the ingredients of EO or EL or Ultra-EP.

<sup>[2]</sup> The literature on relative issues is broad. Among them, the major studies can be seen, for example, in Krueger (1981; 1983; 1993), Bhagwati (1986; 1988), Bhagwati and Srinivasan (1979), World Bank (1987), and Papageorgiou *et al.* (1991). For a survey, see Pack (1988), Bruton (1989), and Edwards (1992).

[3] Meng Xiangang, director of the Department of Foreign Trade and Economy in the State Economic and Trade Commission, pointed out recently as follows: "Our imports are mainly capital goods, including some key equipment for the domestic economic development and resource products that are scarce in the country". (Meng Xiangang 1997)

[4] The import value of equipment and raw materials is the sum of SITC 2 (non-edible raw materials), 3 (mineral fuels, lubricants and related materials), 4 (animal and vegetable oils, fats and wax), 5 (chemical and related products), 6 (light and textile industrial products, rubber products, mineral metallurgical products), and 7 (machinery and transport equipment) subtracting some items which imported as consumer goods. The subtracted items include: medicinal and pharmaceutical products, perfumed materials, cosmetics, leather products, travel articles, etc. in SITC 5; knitted or crocheted garments and clothing accessories, footwear, headwear, processed feather, artificial flowers, natural or cultivated pearls, precious stones and metal, jewellery, etc. in SITC 6; recorders, videorecorders and accessories, etc. in SITC 7. The results of estimate are as follows:

<i>Shares of Equipment and Raw Materials in Total Imports (1985-1996)</i>	<i>(%)</i>							
	1985	1990	1991	1992	1993	1994	1995	1996
Shares in total imports	76.8	66.9	68.3	71.7	80.0	89.1	84.7	86.6

Source: Author's estimate, based on the data from State Statistical Bureau (1992, 1995, 1996b, 1997b).

[5] Some Chinese scholars argued that China has in fact suffered from such a "immiserising export". In their opinion, "compulsory export" contains a risk of causing an "immiserising growth" of exports. "Immiserising export", which refers to export growth that depends on the increase of exports in physical volume instead of in value (price), will be the result of the export-bias. Wang Xinkui (1994) gave a concise description of this, based on Chinese export performance in the 1980s.

In fact, change in terms of trade is a normal phenomenon in world trade. Even China's exports were expanded with a decline in terms of trade, it is unnecessary to be considered the case of "immiserising growth". To a maximum, China's quantitative expansion of exports might suffer from an effect of low efficiency rather than being an "immiserising growth".

[6] Besides the data shown in Table 3.3, the deterioration in terms of trade has been noted in some other Chinese sources (for example, Wang Zixian 1993; Han Yi 1995). The following table shows the changes in China's terms of trade in the 1980s:

<i>Terms of Trade (1980-90)</i>	<i>(1980 = 100)</i>				
	1980	1987	1988	1989	1990
Terms of trade	100.0	105.4	90.7	82.4	96.6

Source: Almanac of China's Foreign Economic Relations and Trade, 1991.

[7] China is one of the six large countries (the former Soviet Union, the USA, China, Canada, Australia and South Africa) with richest natural resources in the world. However, with a large population, China's natural resources per head are below the average level of the world. The following table based on the data of the late 1980s shows some aspects of China's natural resource per head, compared with some other countries and the average level of the world.

<i>A Comparison of China's Natural Resources Per Head with Some Other Countries</i>	World	China	USA	Canada	Australia	France	UK	India	Mexico
Cultivated land (acres)	0.27	0.09	0.76	1.77	2.84	0.33	0.12	0.21	0.28
Forest area (acres)	0.80	0.11	1.08	13.64	6.41	0.26	0.04	0.09	0.53
Forest cover rate (%)	31.10	12.00	28.90	38.40	13.90	26.70	9.60	22.60	23.10
Forest growing stock (cu. m.)	60.60	9.40	81.80	886.30	63.50	28.60	2.80	4.70	37.70
Prairie (acres)	0.63	0.20	0.98	1.23	26.38	0.21	0.20	0.02	0.90

Source: Xiao Shuoji *et al.* (1992), p. 37.

Given that Chinese population has kept growing since the 1990s and it is difficult to increase unrenewable natural resources, the level of natural resource per head in China is likely to be lower than before.

[8] It is very difficult to calculate China's  $EER_x$  and  $EER_m$  based on published official statistics, due to the lack of complete information about tariffs and non-tariff measures on exports and imports. The lack of internationally comparable prices also becomes difficulty to make an indirect estimation. In fact, China has annually produced its  $EER_x$  data, in Chinese term "average domestic cost of foreign exchange" (*Ping Jun Chu Kou Huan Hui Cheng Ben*) which has a same definition as  $EER_x$ , but never published. Here, China's  $EER_x$  and  $EER_m$  for 1994 are obtained in the following ways:

$EER_x$  uses a figure of “average domestic cost of foreign exchange”, from Huang Xianhai (1996). Similar figure can be seen in Yi Gang (1995) who used the term EER;

$EER_m$  is calculated as  $EER_m = e (1 + t + n)$ , where  $e$  is official exchange rate while  $t$  is average tariff rate and  $n$  is tariff-equivalent of non-tariff measures. Data for  $t$  and  $n$  are from Zhang Shugang *et al.* (1997).

## 4 Formalising Export Policies

Exporting has captured a special position in the Chinese economy. Over time, Chinese leaders and economists have repeatedly stressed that export expansion was the most important aspect for the development of China's foreign trade. To promote export growth, China adopted various measures to provide strong export incentives during the reform period. However, alongside its economic opening, China also faced the task of reforming its export policies to fully engage with the world economy. In particular, China's export policies are required to be formalised in accord with international trade practice in which the market mechanism and neutrality are considered to be the foundations of export promoting measures. This chapter intends to examine export policy formalisation in China.

### 4.1 SUBSIDIES AND PRICES

#### 4.1.1 Subsidies Related to Trade

Subsidy is defined as a payment or other benefits provided by the government to producers/exporters to support their production or exports. There are two kinds of subsidies classified as export subsidy and domestic subsidy. *Export subsidy* occurs when a direct payment or other benefits from government is paid to exporters or producers on the goods which are exported. A *domestic subsidy* is paid to producers on all that is produced regardless of whether the output is for export or the domestic market. An export subsidy clearly affects the prices of export goods while a domestic subsidy has a "less" direct or indirect effects on the trade distortions. In China's statistics, the term "subsidies" in fact covers export subsidies (before 1991), import subsidies (before 1994) and domestic subsidies.

**Table 4.1 Government Subsidies, 1985-1996**

(billions of Yuan)

	1985	1990	1991	1992	1993	1994	1995	1996
Price subsidies	26.18	38.08	37.38	32.16	29.93	31.45	36.49	45.39
Subsidies to loss-making SOEs	50.70	57.89	51.02	44.50	41.13	36.62	32.78	33.74
Total	76.88	95.97	88.40	76.66	71.06	68.07	69.27	79.13

Source: State Statistical Bureau (1996a, 1996b, 1997b); State Planning Committee *et al.* (1997).

Table 4.1 gives figures for China's government subsidies for selected years. The data in Table 4.1 requires some explanation. First, almost all Chinese FTCs are state-owned and are therefore SOEs. Second, China has not officially published figures on export (and import) subsidies in detail. Subsidies to FTCs, either for supporting export expansion or offsetting their losses, are usually included in the total amount of subsidies to SOEs. Third, or at least it was the case before 1991, all FTCs could claim and gain compensation from the government for their losses, whether or not such losses were due to their operational inefficiency or to "external" conditions like the distorted price systems and exchange rates. Therefore, it was believed that all FTCs' losses were offset by government subsidies. Fourth, after the elimination of export and import subsidies, subsidies to FTCs took the forms of domestic subsidy.

In international trade practice, export subsidies are regarded as an "unfair" measure and restricted by international agreement. Before the Uruguay Round, GATT rules distinguish subsidies between export and "other" subsidies and between subsidies on primary and non-primary products. "Other" subsidies and export subsidies on primary products are permitted unless they are demonstrated to have adverse effects on the trade or production of trading partners. Export subsidies on manufactured goods are prohibited for developed countries, but are permitted for developing countries, provided they do not cause serious prejudice to the trade or production of trading partners. In the Uruguay Round, all subsidies are further classified into three categories — prohibited subsidies, actionable subsidies and nonactionable subsidies. Export subsidy is included in the prohibited subsidies category while (actionable) domestic subsidies need to be shown to be without trade-distorting effects. Although developing countries are given a period of time to phase out export subsidies, an increase of export subsidies will never be accepted. However, in practice, it is difficult to judge whether the export subsidies of a country hurt its trading partners' production. Trade friction sometimes derives from the different views of the relative countries on export subsidies.

Export subsidisation was once the most important way for supporting Chinese exports. The target of export subsidy was to enable exporter to fill the gap of export costs (or the domestic prices) over export prices. Because of the lack of systematic data, it is difficult to show the accurate scale of subsidy on exports and imports separately. But some incomplete

information can still provide a rough picture of China's subsidy on foreign trade between 1985 and 1991, the period when export subsidy policy was active. Exports did not require domestic currency subsidies in 1985 but import subsidies exceeded 5 billion *Yuan*. In 1986 losses on exports alone exceeded 7 billion *Yuan* while losses on imports were placed at 12 billion *Yuan* (see Lardy 1992, p. 102). In 1987, export subsidies accounted for 4% of the total value of exports (Fan Baoqing 1994). That means the export subsidy in that year reached 5.88 billion *Yuan* (about US\$1.58 billion). When the foreign trade contract responsibility system was introduced in 1988, the government subsidy for foreign trade was frozen at the 1987 level. Considering export and import subsidies together, in 1987 and the following three years (1988-90), government subsidy for foreign trade was about 20 billion *Yuan* per year (Yao Lin 1991, also see Table 4.3 for reference).<sup>[1]</sup> In 1991, export subsidies were eliminated. Import subsidies were only applied to eight imported products including grain, sugar, fertiliser, steels and pesticide (Qiang Yongchang and Tao Yong 1993). Import subsidies were phased out in 1994.

#### **4.1.2 Analysing the Effects of Subsidies**

##### ***Export Subsidies***

Export subsidies allow exporters to sell their products in a foreign market at a lower price than in the domestic market. Sometimes the price of the subsidised export goods may be well below the costs of production. These effects of prices caused by export subsidies could affect both the exporting country and the importing country. For the importing country, export subsidies in the exporting country means a cheaper source of supply and an opportunity to enjoy an increase of net welfare. But the domestic import-competing industries may be harmed by importing goods subsidised by the exporting country. This has become the main reason for anti-dumping measures. For an exporting country, the effects of export subsidies are also double-edged, given the reduction of welfare on the one hand and expansion of exports and increased export earnings on the other. The use of export subsidy policy in China generated various problems.

The first problem related to the interaction between export subsidies and prices. Conventional analysis of export subsidies usually indicates that such subsidies help maintain the low prices of exported products but induce an increase in domestic prices. The rise of domestic prices in turn requires a further increase in the export subsidy because the

export cost will go up as well. In China's experience, such an interaction started with the rise of domestic prices. Since the beginning of reform, China's price controls were increasingly eased. Market mechanism and administrative measures both resulted in price levels for most commodities being raised.

**Table 4.2 Price Indices, Selected Years**

	1978	1980	1985	1988	1990	1995	1996
<b>General CPI (1985=100)</b>	-	-	100.0	135.8	165.2	302.8	327.9
<b>CPI urban area (1978=100)</b>	100.0	109.5	134.2	188.5	222.0	429.6	467.4
<b>General PPI of farm products (1978=100)</b>	100.0	130.8	166.8	244.5	273.9	527.9	550.1
<b>General EFPI of industrial products (preceding year=100)</b>	-	100.5	108.7	115.0	104.1	114.9	102.9

Note: CPI: consumer price index; PPI: purchasing price index; EFPI: ex-factory price index.

Source: State Statistical Bureau (1996a, 1996b, 1997b); State Planning Committee *et al.* (1997).

Table 4.2 shows that the fast increase of various price indices since the 1980s (prices of agricultural products increased much higher and earlier than others). As a result, in 1985-1990, the purchasing prices of exported goods and the "average domestic cost of foreign exchange" increased 93.6% and 83.33% respectively (Huang Yaohua and Wang Zhengxiao 1991). Further, because of China's "compulsory exports" practice, purchasing the exportables at high prices strengthened the trend of price increase. Some FTCs began to bid increasing prices for exportables which they could sell for foreign exchange, exporting these goods at loss-making competitive prices, cutting out other FTCs (Liu Mingxing *et al.* 1982; Shen Liren 1988; Kleinberg 1990, p. 144; Wang Zixian 1993; Shi Shijun 1995).

The second problem concerned the increasing burden for the government of compensating FTC losses through the use of subsidies. The need for subsidies was due to the low efficiency of the Chinese economy and the severely distorted price system. Due to the rise of the domestic prices which resulted in an increase of the "average domestic cost of foreign exchange", FTCs' exporting and importing losses continuously increased in the 1980s. According to a World Bank report (World Bank 1994a), Chinese FTCs losses on some international transactions were inevitable, due to domestic price distortions and the existence of mandatory export and import plans.

As seen in Table 4.3, in 1986-1990 when export subsidisation was an active policy instrument, more than a half of fiscal subsidies for SOEs (58.53%) went to the FTCs. The situation since 1991 seemed improved, given that the subsidies to foreign trade accounted for a lower proportion of total subsidies provided to SOEs, due partially to the elimination

of export subsidies from 1 January 1991. Nonetheless, the budgeted subsidies for foreign trade in 1986-1991 totalled 153.71 billion *Yuan*, accounting for 5.82% of the real total value of imports and exports (2,642.82 billion *Yuan*) in this period. The above figures do not provide a complete picture. Between 1988 and 1990, besides the FTC losses which covered by subsidies from the central government budgets (about 82.93 billion *Yuan*), there was also an extra loss of 15 billion *Yuan* (Huang Yaohua and Wang Zhengxiao 1991). As already mentioned, all losses of FTCs were finally paid for by the government.

**Table 4.3** *Losses of FTCs and Government Subsidies to SOEs* (billions of *Yuan*)

Year	1986	1987	1988	1989	1990	1991	1992	1993
Subsidies to FTCs	24.96	28.21	26.85	26.89	22.36	11.85	3.77	2.13
Subsidies to loss-making SOEs	32.48	37.64	44.65	59.89	57.89	51.02	44.50	41.13
FTCs' share in subsidies to SOEs (%)	76.85	74.95	60.13	44.90	38.62	23.23	8.47	5.18

Source: World Bank (1994a, p. 26) for data of subsidies to FTCs 1986-1988. The Editorial Board of *Almanac of China's Economy* (1993, 1994) for data of subsidies to FTCs 1989-1993, "Subsidies to loss-making SOEs" are taken from State Statistical Bureau (1997b), p. 239.

Third, the export expansion effect of export subsidies not only helped overcome inadequate demand in the domestic market, but also brought about the development of other sectors. Using subsidies to promote exports may change domestic consumption expenditure into investment on the one hand, and increase foreign exchange earnings on the other. So the effect of subsidies in stimulating national economic growth can be larger than the losses caused by the worsened terms of trade. Traditionally, China's exports largely relied on the low prices of export goods. The use of subsidies in China during the second half of the 1980s was also an attempt to take advantage of low price to expand exports. By subsidising exports, some industries, such as the mechanical and electrical equipment industry, textile and garment industry and other light industries, grew rapidly in the 1980s and became major exporting industries. The export value of the mechanical and electrical equipment industry, for example, grew from US\$1.41 billion in 1980 to US\$48.21 billion in 1996, accounting for 31.9% of China's total exports. The average annual growth rates in the periods of 1981-1985, 1986-1990 and 1991-1996 were 2.77%, 42.01% and 25.90% respectively. The mechanical and electrical equipment industry was one of the industries benefiting from strong protection in China. Apart from other protection measures, export subsidies certainly played a very important role in promoting the exports of this industry, given that most products of this industry were exported in a loss-making situation (Guo Fuhua 1992). Since the elimination of export subsidies in 1991, China has used other



measures including tax exemptions and export financing to continue providing support to the mechanical and electrical equipment industry.

### ***Domestic Subsidies***

When export subsidies were eliminated, domestic subsidies remained an important source for compensating FTC's exporting losses. Domestic subsidies may take various forms including tax reduction or exemption, preferential credit, the availability of public infrastructure (or other) goods at lower prices (price subsidies) and subsidies to loss-making enterprises. The initial intention of domestic subsidies is not for trade expansion but such subsidies do affect exports and imports. It is difficult, however, to identify the extent in which foreign trade has benefited from domestic subsidies.

What is clear, however, is that China's exports were supported by preferential treatment of production and exporting activities. The following rough estimate, taking the year 1995 as example, may provide an impression of China's domestic subsidies relative to the foreign trade. In 1995, government subsidies were 69.27 billion *Yuan* (see Table 4.1). On the assumption that all sectors benefited equally from government subsidies, the amount of the subsidies to foreign trade would be 5.55 billion *Yuan* (US\$0.66 billion). Import tariff exemption for processing trade was worth US\$20.95 billion (processing imports of US\$58.37 billion times nominal tariff rate 35.9%). Other imports (general imports) might also enjoy tariff exemption or reduction but it is impossible to ensure the proportion relative to exports and therefore this part is ignored in this estimation. A conservative estimate could be that in 1995 there was at least US\$21.4 billion of domestic subsidies relative to China's foreign trade, accounting for about 7.6% of the total trade in the year (US\$280.85 billion).

From the above analysis, some points can be made. First, the use of subsidies has helped some industries to develop. To some extent, subsidies became one of the factors supporting China's high growth rate of exports, given that most of China's major exporting industries have been heavily subsidised. Second, subsidies on trade have in fact maintained the separation of domestic prices from those of the world markets, and aggravated price distortions which resulted in increasing FTC's losses. Third, through subsidising exports directly or indirectly, the government has lost a large amount of fiscal revenue and increased its fiscal expenditure. All revenue losses and fiscal expenditure lowered the real

significance of China's rapid growth of exports. Fourth, although export subsidies have been eliminated, domestic subsidies are still playing an active role in supporting export growth. Finally, because all losses could be offset by subsidisation, FTCs lacked the necessary incentives to improve their operational efficiency.

Indeed, once subsidisation was extensively used and became a source for fostering inefficiency of enterprises, such subsidisation policy becomes harmful for promoting economic growth. In China, experience showed that the priority of subsidy policy was targeting foreign exchange earnings instead of encouraging technological innovation to enter foreign markets. Therefore, many enterprises depended on subsidies to engage in export operations. They lacked incentives or pressure to improve efficiency, since subsidies enabled them to compensate for any losses from exports. Moreover, China is a developing country and has been transforming itself towards a market economy. Subsidies are problematic in the context of market mechanisms because they may become a source of market distortion. By contrast, reducing subsidies will force enterprises to become responsible for their profits and losses instead of depending on government financial assistance. From this viewpoint, the elimination of export subsidies in 1991 was certainly an important measure in the formalisation of China's export policies.

#### **4.2 EXCHANGE RATE AND FOREIGN-EXCHANGE RETENTION**

Foreign exchange policy affects many aspects of an economy, not just only the foreign trade. It is not a "pure" trade policy. However, foreign exchange policy is one of the most important factors influencing foreign trade because every foreign trade activity must face questions relating to the accessibility of foreign exchange, the convertibility of domestic currency and changes in exchange rates.

In developing countries following an IS regime, a common problem is "foreign exchange shortage", due to the obstacles facing exports. Exchange control measures are usually introduced as a response (Krueger 1981b). Like most developing countries, China has had a period of chronic foreign exchange shortage. This situation made the Chinese authorities adopt a policy solution in which both increasing foreign exchange earnings has been much encouraged and restricting the access to foreign exchange has been much emphasised. Such a policy was reflected in the introduction and subsequent elimination of the foreign-exchange retention system and in the changes to the exchange rate system.

Foreign exchange policy has been one of the most important instruments used to control foreign trade.

#### **4.2.1 Using Foreign Exchange Policies to Promote Exports**

##### ***The Foreign-Exchange Retention System***

In 1979, as noted earlier, a foreign exchange retention (FER) system was introduced to provide incentives to exporters. Exporters were allowed to retain a certain proportion of foreign exchange from their export earnings. The rights and rates of exchange retention were largely determined by the factors such as the nature of the export product, the export growth pattern and the performance of the exporter.

This system started with a complex formula and was adjusted several times. In the beginning, the rates of retention were relatively simple. The retention shares were 20% and 40% respectively for the exported goods produced by the enterprises under central government supervision and for those under local government supervision. The retained share was divided equally between enterprise and its supervising authority. For export proceeds of export-processing enterprises and compensation trade, the share was 15% of net earnings, and for fees from simple processing and assembly of foreign components it was 30% (Cheng Hang-Sheng 1993). After 1982, the retention rates became more complex. More and more export goods were included in the retention system and the retention rates were varied between 5% and 25% from product to product, from sector to sector and from province to province.

A unified 25% retention rate was applied to most provinces in 1985, with preferential rates for certain favoured regions (Guandong — 30% at general level and 100% for SEZs, Fujian and some remote provinces) and some industries (for example, the mechanical and electrical industry). Several years later, during the period of implementing the foreign trade contract responsibility system (1988-91), the retention rates were regulated along two lines. Within the assigned target of exchange earnings, 80% was handed over to the central government and 20% was retained by contracted enterprise. For excess earnings, 20% were handed over to the central government and 80% were retained by the contracted enterprise. For selected industries in reform trials (Light industry, Handicraft industry and Garment industry) the retention rate was 100%.

In 1991, the FER system was shifted from regionally different retention rates to a structure of retention rates based on the categories of export products. A unified 80% retention rate applied to all export earnings, within this proportion 30% had to be sold to the state bank. This structure of retention rates basically remained in force until 1993, although some small adjustments were made to increase incentives to exports in some regions and industries. In 1994, the FER system was phased out.

### ***Exchange Rate System***

When China adopted an import substitution strategy to develop the national economy, the exchange rate policy was a fixed exchange rate system based on an overvalued exchange rate. The overvaluation of *Renminbi* became a serious obstacle to export promotion. The introduction of the exchange retention system did not solve the problem of balance between export costs and export earnings. Measures were therefore taken to strengthen export incentives. These measures were the use of multiple exchange rates and devaluation.

In 1981, China adopted a dual-exchange-rate system. The dual-exchange-rate system initially took the form of an “internal settlement rate” alongside the official rate, using different exchange rates for different categories of exports. The earnings from some government targeted exports could be converted into domestic currency at a preferential “internal settlement rate” that was usually higher than the official rate. The internal settlement rate was set at 2.8 *Yuan* to the Dollar while the official rate was 1.53 *Yuan* to the Dollar (Zhou Xiaochun 1990). The immediate result of this system was that enterprises were given differential financial treatments, given that some were encouraged while others were in fact discriminated against; creating unfair competition.

In 1985, the “internal settlement rate” system was abolished. However the dual-exchange-rate was not phased out. It took another form in which a “swap rate” coexisted with the official rate. As early as 1980, a tentative step of exchange system reform, through the establishment of “foreign exchange adjustment centres”, was taken to release the tight control over access to foreign exchange. This measure provided a significant alternative to the foreign-exchange control authorities as a channel for obtaining foreign exchange on the one hand, and enabling foreign exchange to flow between enterprises on the other.

After the elimination of the “internal settlement rate” system in 1985, the importance of the exchange swap (adjustment) system increased. The effect of the exchange swap system was to provide a preferential rate for converting export earnings to domestic currency for exporters, because the swap rates, like the internal settlement rate, were always higher than official exchange rates. The difference between swap rate and the internal settlement rate was that the swap rate applied to exporters instead of to products. By 1988, foreign exchange swap centres were operating in all provinces and the swap rate was allowed to float. In addition, an increasing number of enterprises, including foreign-funded enterprises, were permitted access to swap centres and the proportion of foreign-exchange allowed to be swapped increased. The function of the foreign-exchange swap system became more important. The total volume of exchange transactions was US\$4.2 billion in 1987, US\$6.3 billion in 1988, US\$8.5 billion in 1989, US\$20.4 billion in 1991 and US\$25.1 billion in 1992 (Cheng Hang-Sheng 1993; Fan Baoqing 1994). At the end of 1993, more than 80% of export and import trade was using the swap/adjustment rate. The official exchange rate of 5.8 *Yuan* to the Dollar at that time almost could not be obtained in practice for trade transactions (Wang Zixian 1994; Yang Xiaobin 1994).

The exchange policy reform also witnessed the devaluation of the Chinese domestic currency. The reason for the existence of the dual exchange rate system rested on the unrealistic setting of the official exchange rate, with an severe overvaluation of the domestic currency. Thus, the real problem seemed to be the unrealistic exchange rate of the *Renminbi*. Under the dual-exchange-rate system, the “internal settlement” or “swap” rate in practice was to provide incentive to exporters. However, it obviously derived from common international practices. Unifying the dual-rate system and marketising the exchange rate formation mechanism became crucial elements of Chinese trade reforms. In the 1980s and the early 1990s, China adopted a slow-pace devaluation policy to cut down the difference between official exchange rate and real market rates (swap rate and black market rate). In 1994, China unified the dual-rate system and established a unitary managed floating exchange rate system based on the market mechanism. Thereafter, the system allowing enterprises to retain a portion of foreign exchange was abolished, and replaced by a system of settlement and sales of foreign exchange.

#### **4.2.2 Impacts of Foreign Exchange Reform**

##### ***What is to Be Retained?***

The introduction of the FER system was an administrative measure to strengthen incentives for export expansion. It functioned in the following ways: First, allowing a proportion of export earnings to be retained by exporting enterprises improved accessibility to foreign exchange. In a country like China which was under a planned regime, foreign exchange control restrained enterprise's access to foreign equipment and technology and other profitable import activities. The implementation of the FER system in fact reflected a limited relaxation of the strict foreign exchange control. The retention rate(s) indicated the extent to which the control on foreign exchange was eased. The accessibility to foreign exchange for individual enterprises, through the FER system, increased the enterprise's capacity to engage in some other import or activities to make use of foreign advanced production facilities which may results in a higher profitability.

Second, under a dual exchange rate system, the retained foreign exchange may be an additional source increasing the total revenue of the exporting enterprises. While the retained exporting earnings could be converted into domestic currency at the "swap rate", which was usually higher than the official rate, the exporting enterprise's total domestic currency income was enhanced. The higher the retention rate, the larger the export income in domestic currency would be. This partial devaluation, an actual depreciation only for exports in the settlement phase, created incentives solely for exporting enterprises to offset the anti-export bias under an IS regime. A further effect of this partial devaluation was that it avoided the overall shocks of price changes which usually result from a real devaluation and helped maintaining China's general trade policy of encouraging exports while imports were strictly restrained.

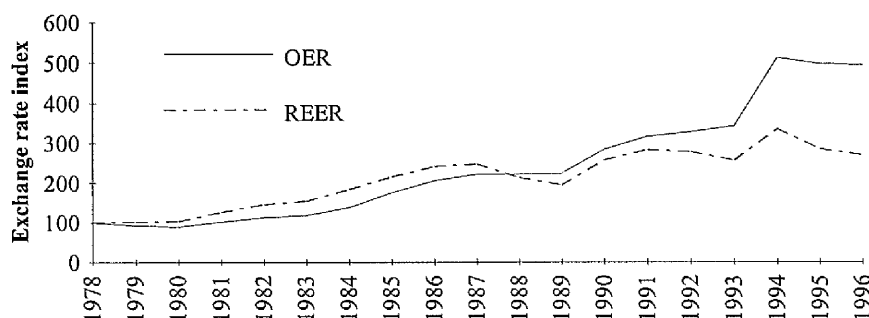
On the whole, the FER system was initially a remedy for the restrictions of the foreign exchange control system. What was retained was not only the earning of foreign exchange but also the right for enterprises to achieve higher revenue and to arrange further development with less government control. Such benefits enabled the FER system to become another major incentive for export expansion in the 1980s until its elimination in 1994. Moreover, the elimination of the FER system did not mean such an incentive was reduced. Instead, export promotion policy was reinforced because enterprises no longer had an obligation to hand over exchange earnings to the state. In view of that, autonomy in the

use of foreign exchange expanded, and enterprises were given a stronger stimulus to increase exchange earnings.

### ***Getting the Exchange Rate Realistic***

Figure 4.1 shows the trends in official exchange rates and real effective exchange rates (REER) of the *Renminbi*. It can be seen that the *Renminbi* depreciated dramatically from the 1980s on. In particular, since the mid-1980s, the heavy inflation pressure is reflected in a continuous decrease of the REER and its divergence from the nominal exchange rates. But the large real depreciation seemed to be an effort to correct the overvaluation of the *Renminbi*.

**Figure 4.1 Official Exchange Rates and REERs  
(Index 1978=100)**



Note: In this figure, REER was calculated as  $REER = \text{official exchange rate} * (\text{US consumer price index} / \text{China's consumer price index})$ .

Source: IMF, *International Financial Statistics Yearbook*, various issues; State Statistical Bureau, *China Statistical Yearbook*, various issues.

The reform of the exchange rate system brought out some immediate and potential impacts on the development of Chinese foreign trade. First, the value of *Renminbi* has been largely devalued since the 1980s. The nominal exchange rate (the US Dollar to the *Renminbi*) increased from 1.4984 *Yuan* in 1980 to 8.6187 *Yuan* in 1994, implying a depreciation of 475.19%. The REER index (1978=100) also increased from 102.7 in 1980 to 269.1 in 1994, indicating a real depreciation of 162.03%. Adopting such a large depreciation without severe social and economic chaos should be considered a successful transformation of China's exchange rate system.

Second, the change in the real exchange rate had significant effects on China's exports and imports. In 1994 when China unified its foreign exchange rate system, the nominal

exchange rate was set up at US\$1=8.7 *Yuan*. The unified exchange rate supports the trend towards export promotion while not adding any discrimination against imports. The possible decrease of imports would be due to the end of the *de facto* position encouraged under the IS regime, not a result of exchange-rate-biased policy. According to a study by the Research Department of China Aggregate Development Research Academy (RDCADRA 1995), regression results show that when the real exchange rate is increased by 1 *Yuan*, exports may increase by US\$18 billion and imports may decrease by US\$6.53 billion.

Third, the balance of trade depended on the real exchange rate, especially the annual rate of change of the real exchange rate. When the degree of change is smaller than the previous year, the balance of trade may worsen. That means the accelerated devaluation of *Renminbi* became an instrument for maintaining the balance of trade (RDCADRA 1995). The unified exchange rate can help to avoid sharp fluctuations in the exchange rate caused by speculation and profiteering.

Finally, and more importantly, the marketisation of exchange rate formation changed the situation of unrealistic overestimation of the *Renminbi*. It provided a foundation for correcting the distortion of trade policy. The unification of the dual exchange rate was a precondition for integrating China's economy into the international economy. The measures complementing the unification of dual rates, such as the elimination of the exchange retention system, will facilitate the rationalisation of the relationships between enterprises and their authorities. The unification of the exchange rates was aimed at long-term development. It is important to realise that the unification of exchange rates was the only way in which the exchange rate system of the *Renminbi* could be made compatible with the internationally standardised floating exchange rate system.

### **4.3 DUTY DRAWBACK SYSTEM**

#### **4.3.1 Duty Drawback and Export Promotion**

To encourage export expansion, in April 1985, China adopted a duty drawback system in which the indirect tax levied on exported goods was refunded to the exporters. The duty drawback system was initiated in accordance with international practice. More importantly, it strengthened the competitiveness of exported goods through tax refunds, which enabled exported goods to enter international markets without domestic indirect taxes.



### ***The Implementation of the Duty Drawback System***

In 1985, when the tax rebate policy started, the national amount of duty drawback was only 1.98 billion *Yuan*. The main export promotion measures at that time seemed the use of export subsidies and tax exemption. However, with the extensive implication of the duty drawback system and the rapid growth of exports, the total amount of duty drawback exceeded 10 billion *Yuan* by the end of the 1980s and reached 20 billion *Yuan* in the early 1990s (Zhu Wenhui 1996a). The elimination of export subsidies since 1991 reinforced the role of the duty drawback system in the export promotion mechanism. The duty drawback system became an increasingly important source to offset export losses and to increase export earnings through reducing export costs. By 1994 when China adopted a policy ensuring a zero-rate of tax for exported goods, the amount of duty drawback reached 44.78 billion *Yuan*, 48.5% higher than that of the previous year. In 1996, the duty drawback increased to 82.6 billion *Yuan* (*China Business Times* 20/2/1997).

**Table 4.4** *Export Tax Rebates*

(billions of *Yuan*)

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Amount of rebates	1.98	4.20	7.40	12.0	18.0	n.a.	n.a.	n.a.	30.2	44.5	55.0	82.6

Source: Lardy (1992), p. 50; *China Economic News* (No. 36, 18/9/1995); Zhou Fuxiang and Qi Yuanjun (1996); Yang Fan (1996); *China Business Times* 20/2/1997.

The implementation of the duty drawback system was one step in the process towards normalising the export incentive mechanism. This system has played an increasingly important role in promoting exports. In 1994, in particular, the reform of the exchange rate system limited the possibility that trade companies could obtain profits from imports and benefit from the sale of export earnings at the swap rate. Possible substitute measures for export promotion seemed relying on devaluation and tax rebates. However, the effect of devaluation in 1994 was thought not strong enough to push the increase of exports (Pei Ping 1994; Zhu Wenhui 1996a). The export duty drawback therefore became the main source pushing the export growth. The growth rate of exports in 1994 reached 30%.

### ***Duty Drawback Rates***

Before 1994, China used a taxation system with the consolidated industrial and commercial taxes in the centre. These taxes were usually levied each time when products were transferred in the production circulation. The prices of final goods had a tax

component that varied significantly depending on the number of stages in the production process. The calculation of duty drawback was extremely complex. It took a significant amount of time to investigate the indirect tax component in the prices of exported goods. The rebate rates varied from commodity to commodity. The average rate of rebate was 11.2% (Wang Yi 1996; Yang Fan 1996b). The method of duty drawback was to make a national duty drawback plan according to enterprises' export plans. Then the central fiscal department paid the planned tax refunds to the exporters after confirming their real exports. The central government would not absorb the cost of duty drawback for over-plan exports (Wang Suqing 1992). Since 1994, however, a new taxation system with value-added tax, consumption tax, business tax and personal income tax has been introduced to rationalise the tax structure. The rebate rates before the 1995 adjustment were divided into two levels, 13% and 17%, 17% being the average nominal rate of indirect tax burden. By converting these two rates into the tax component of price, the average rate of rebate was 14.2% (Wang Yi 1996). However, due to some preferential and exemption measures launched soon after the implementation of the new tax system, the actual tax burden on exported goods was about 10%, 4.2 percentage points lower than the rebate rate (14.2%). This meant some exporters might get 4.2% of total exports as "extra income" by claiming export duty rebates.

The decline of the real tax burden and the increase of rebate expenditure forced the government to adjust the rebate rates twice. The first time was in July 1995. The State Council decided the rebate rate for agricultural products and coal should be 3%, while the rebate rate for manufactured goods produced using agricultural raw materials and some other products subject to 13% value-added tax would be reduced to 10% and the rebate rate of the products with 17% of value-added tax would be reduced to 14%. The aggregate rate of rebate actually declined by 3 percentage points. The second adjustment was in January 1996. The rebate rates were then reduced from 10% and 14% to 6% and 9% respectively (Zhu Wenhui 1996a). By these two adjustments, the average rate of rebate decreased by about 50%. The immediate effect was that the central fiscal expenditure was reduced. On the base of the 1994 level, the reduced expense on export rebate would be at least 20-22 billion *Yuan* per year. Although the duty drawbacks have been reduced, exports kept growing in 1995. Total exports in 1995 were US\$148.77 billion, up 22.9 percent (*People's Daily*, overseas edition, 13/01/96). However, much of this took place in the first six months in anticipation of the reduced duty drawback rates. According to Chinese customs statistics, export growth rates

compared with the same period of the previous year increased from 33.0% in the second half of 1994 to 44.0% in the first half of 1995 but dropped to 8.7% in the second half of 1995 and to -8.2% in the first half of 1996.

#### **4.3.2 Issues Concerning the Duty Drawback System**

It is important to draw a distinction between export subsidy and duty drawback. Export subsidy is a price-distorting support to exports aimed at an expansion of export markets with the advantage of low prices. Because of its feature of “unfair competition”, export subsidy is prohibited by the GATT/WTO rules. Duty drawback can be considered a price-correcting measure in international transactions by avoiding repeated taxation on traded goods.

The duty drawback system may generate different effects. First, consumers in the importing country do not need to pay indirect taxes levied in the exporting country in addition to those taxes levied in the importing country. It ensures the best protection of consumer interest with regard to consumption of imported goods. Second, a zero-rate of tax on export goods, by which the differences of taxation systems in different countries can be excluded, may lead to fair competition in the world market. For the exporting country, the duty drawback system helps to reduce the anti-export bias given that neither export sector nor import-competing industries will be discriminated against. Third, by taking off domestic indirect taxes from the export goods, exporters can lower the export prices and restore the real comparative advantage which helps to rationalise the trade structure of the exporting country. Considering the above reasons, the duty drawback system is generally a neutral instrument compatible with trade liberalisation. In the GATT and WTO rules, it is clearly stated that duty drawback should not be considered as a kind of subsidy.

Using the duty drawback system appropriately is never an easy task, especially when it is newly introduced into an economy. In China's experience, there were some problems in the implementation of the duty drawback system. One problem was that the surge in duty drawback refunds brought the government a large fiscal burden. The growth rate of the claimed rebates was even higher than that of export growth in some years. This meant the expansion of exports did not increase as much as expected revenue, and reduced the existing level of the revenue. In addition, due to the difference between the nominal rate of tax and the much lower rate of actual tax burden which was resulted from the excessive use

of preferential policies, the extra amount of export duty drawback paid by the government reached as large as 16.8 billion *Yuan* in 1994, approximately one third of the total duty drawback in the year (An Tifu and Liang Peng 1996).

A further problem was that many tax-cheating cases occurred, due to the incomplete managerial system. According to statistics, the amount of duty drawback from cheating accounted for about one fifth of the total amount of rebates in 1994 (Zhu Wenhui 1996a).

The third and the most notable problem concerned the rate of rebate — the duty drawback policy itself. In particular, the second reduction of duty drawback rate in 1996 produced a greater pressure on export enterprises. In 1996, China's exports experienced the lowest growth rate since the 1980s. The reduction of duty drawback rate was quoted as a main cause of the export slide-down. First, the reduction of duty drawback rate increased export costs. In world markets, export prices are decided through competition. It is impossible in most cases to increase an export price unilaterally to compensate for the extra burden caused by the reduction of duty drawback rate. Equally FTCs also could not force down the prices when they were purchasing export commodities from production enterprises because of the prices of raw materials also went up sharply in recent years. The effective way forward was to reduce trade costs and improve export structure, but this process would take time. Second, considering the fact that the duty drawback rates (9% and 6%) were lower than the nominal indirect tax rate (17%) or the actual tax burden of exported goods (10%), some enterprises could not export on a tax neutral basis. Indeed, China intended to apply zero-rate of tax to export products. But the two reductions of duty drawback rates seemed against this intention. Third, delays in the payment of duty drawback tied up enterprises' circulating capital. In some cases, by the first half of 1996, the accumulation of unpaid duty drawback for an individual FTC was up to 1 billion *Yuan*. At the national level, by the end of 1996, the total accumulated unpaid duty drawback was about 50-60 billion *Yuan* (Fan Zhigang 1997). According to some estimates, the interest losses caused by the unpaid duty drawback for all FTCs reached 5.5 billion *Yuan* (Ling Ye and Zhu Naixiao 1996; Zhu Linan 1996).

It was believed that the reduction of duty drawback rate would produce a positive effect in improving the export structure. Trading enterprises would be forced to balance the costs

and profits through developing high value-added export products. Those small size enterprises with weak competitive power would be eliminated through competition and the structure of exports should be improved. However, reducing the rate of duty drawback has been used as a means by which the central government transferred its fiscal difficulty to trade enterprises. This unfavourable condition for exporters may once again distort resource allocation, shifting inputs to non-export sectors and generating pressure on external payments. China's duty drawback system, in this sense, has not really been a neutral mechanism providing fair incentives for export enterprises. The fall in the export growth rate from 22.9% in 1995 to 1.5% in 1996 sounded the alarm.

#### **4.4 OTHER EXPORT INCENTIVES**

##### **4.4.1 Export Financing**

Three kinds of export financing needed for exporters are pre-shipment credit, post-shipment credit and investment credit. Besides general forms of export finance for direct exporters such as seller's and buyer's credits directly obtained from banks, using domestic letters of credit is an effective measure to provide financial support for indirect exporters (export producers). Export producers (indirect exporters) may obtain credit from banks when they can produce a domestic letter of credit they have received from direct exporters or FTCs (World Bank 1987, Box 2.6).

##### ***The Size of Export Financing***

Until 1994 when the China Import-Export Bank was set up, China had no specialised institution providing export financing support for exporters. However, export loans have long been a preferential policy instrument in China's financial policy. Exporters could obtain loans, if necessary, from other banks. Financial support for exporters in China were mainly investment in export production and working capital for FTCs. For example, the Bank of China has long been executing a preferential policy towards the foreign trade sector. Over 80% of the loans in domestic currency were given to foreign trade, industrial-trade, foreign-funded and export production enterprises. By 1994, the accumulated amount of loans provided by the Bank of China for foreign trade enterprises was 444.6 billion *Yuan*. Of this, export production loans reached 6.3 billion *Yuan* (Yang Huiqiu 1995).

A World Bank report (1994a) gave some further details about export financing in China, indicating that trade credit grew rapidly between 1985 and 1991. As the report points out,

the ratio of export credit to total exports was very high. In 1988/1989, 90% percent of new trade loans were used to finance exports. Export loans in that year would have amounted to an estimated 150% of the actual volume of exports (World Bank 1994a, p. 127).

Apart from general loans for establishing and developing export production, the Bank of China, and then other national banks, also provided foreign exchange loans in forms of export seller's credit since 1978 and buyer's credit after 1992. In 1994, China Import-Export Bank was set up as a new policy bank to manage export financing. The aim was to use financial means to support China's exports, particularly the exports of machinery and electric products and complete set of equipment. By the end of 1996, the China Import-Export Bank had approved US\$54 million of export seller's credit to support machinery and electric product exports of a contracted amount of US\$7.26 billion (Lei Zuhua 1997).

### *The Motives and Effects of Export Financing*

Two reasons may explain such a preference for financing exports. First, export expansion was traditionally a favoured sector for government encouragement. Exporting was regarded as the key to industrialisation and economic growth. Exportable production became one of the areas supported by government industrial policies (State Council 1989, 1994). Export earning was an important indicator for examining an enterprise's achievements (Zheng Chaoyu and Wei Wei 1994; Wang Xinkui 1994). This induced some preferential policies in favour of exports.

Second, financial institutions favoured export loans, partly because of the relatively small risk associated with most of these loans which were applied to existing orders and partly because of the administrative interventions from central or local governments. Evidence of this favouritism was seen in the greater efficiency in approving loan applications from export enterprises. Before the mid-1980s, most loans were controlled by state mandatory plans. After the reforms began in 1984/1985, banks were granted rights, to some extent, to decide the allocation of loans, although the final right of judgement remained with government (Singh 1992, pp. 63-64).

The rapid increase in foreign trade credit reflected the importance of export financing in the trade growth. This situation was due firstly to the efforts of FTCs to develop new bases for exports for which a large amount of medium- or long-term investment was needed, and

secondly in some cases to the low productivity in production and trade enterprises. The real reason may be that most FTCs and export production enterprises had not been changed to real independent entities responsible for their profits and losses. There was also a lack of a hard budget constraint for enterprises which might have forced them to enhance the efficiency of resource utilisation. This circumstance was even severe when many manufacturing enterprises had no direct trading rights and could not directly access the earmarked trade credits provided by the central or local governments.

Moreover, loans for exports could be obtained under preferential conditions including low interest rate. One example was that of the Bank of China providing export commodity purchasing loans and export credit for machinery and electrical manufactures under preferential interest rates for foreign trade enterprises (Yang Huiqiu 1995). Generally, the preferential interest rate for export loans was usually two percentage points lower than the market rate (The Project Research Team of UIBE 1994). In addition, it was also easier for export projects to obtain loans from banks. However, in the WTO rules, providing export loans under preferential conditions is regarded as a kind of export subsidy and therefore prohibited. To conform with international trade practice, in 1995, China phased out the policy offering preferential conditions for export loans.

#### **4.4.2 Industrial Policies**

Industrial policies, as distinctive from trade policies, are defined as government efforts to alter industrial structure to promote productivity-based growth (World Bank 1993, p. 304). Industrial policies are commonly used in developing countries to encourage certain sectors. The argument for using industrial policy is that, in a weak market or a market with market failures, the rationalisation of industry requires government intervention to allocate resources between sectors, protect “infant” industries, and promote the country’s products. In the countries adopting industrial policies, trade policies usually feature specific preferential treatment for the government’s “picked winners”.

The use of industrial policies, typically providing subsidies to the chosen firms or industries, may help establish certain industries as the leading sectors of the economy for growth. Hughes (1995) notes that, unlike Hong Kong and Singapore where free trade was the core trend of policy direction, Taiwan and Korea had employed strong protectionist policies to support their protected industries in the 1960s and 1970s. However, such

policies may easily generate demand for government intervention and trade protection. Furthermore, incentives for exports and resulting distorted price system are likely to affect resource reallocation.

Before reform China had no specific industrial policies, since nearly all industries were in protected development. Certain industrial policies emerged as an alternative to reducing the previous excessive overall protection, in the course of China's gradual strategy of reforming and opening-up the economy. In practice, since the 1980s, China has tried to produce some industrial policy support for the preferred sectors such as textiles, electronic, machinery, iron and steel, and automobile industries.

The effects of industrial policies in the 1980s have varied and have not been tied closely to trade policies. China had used supportive policies to encourage the development of the textile industry and these policies have been seen to be successful in the first half of the 1980s (Lu Zheng 1993). But the overall implementation of industrial policy has been ineffective. The reasons for this are as follows. First, the industrial policies did not fit the requirements of a developing market economy. The basis of industrial policy was still the planned economy which emphasises the aggregate balance of the economy, instead of comparative advantage. Second, there was a lack of workable measures to support the implementation of industrial policy. The main instrument was still administrative control. The market mechanism has not fully acted as the main power in the distribution of resources. Third, there was failure to systematically combine trade policy with industrial policy. China's preferential trade policy was initiated with an emphasis on regional openness, instead of on a sectoral strategy. Local governments provided various preferential trade policies, some of them exceeding that on the national level, for the enterprises within their territories. Many low efficiency enterprises obtained stimulus from these preferential policies and developed rapidly. For example, in the case of iron and steel industry, large and mid-scale enterprises should have been encouraged according to industrial policy. However, most large-scale iron and steel enterprises were tightly controlled. At the same time, some small local enterprises, including some of those which have been supposed to be restrained by industrial policy, have developed rapidly due to regional protectionism and preferential policy measures provided by local governments (Xiong Zhijun 1993).



Being aware of the weakness of the previous industrial policy, the State Council of China announced a new “*Outline of the National Industrial Policy in the 1990s*” in March 1994, five years after the first industrial policy package (March 1989). In this new guidance document, enterprises which manufacture products with comparative advantage, high added-value and competitiveness are encouraged to export. The state will support the imports of new technology and relevant equipment and the imports for some infant industries. Concerning the measures for implication, the Outline stresses that industrial policy must be matched by relevant economic policies, in particular public finance, taxation, prices, finance, foreign trade and investment policies. It seems that the linkage between industrial policy and trade policy has now been considered. But the effect will take some years to be felt.

The reinforcements of industrial and trade policies were two-layered. Industrial policies may, but not always, become a source of protection. Biased industrial policies and export incentives may cause trade policy distortions while promoting the growth of exports. The correction of the distortions has also led to demands for more and more complicated industrial policies. The growth of international competitiveness along with a rapid increase of exports can provide the basis for trade policy liberalisation after the initial stage of outward-looking development. The issue now facing China is how its adoption of industrial policies might not be seen as a type of trade protection against trade liberalisation.

#### **4.4.3 Encouraging Exports from Foreign-Funded Enterprises**

Encouraging the development of foreign-funded enterprises in order to expand exports has been an important export promotion policy in China. For the purposes of attracting foreign investment, China also substantially devolved the management power to provincial and local governments, particularly to the eastern coastal provinces, to simplify the investment approval procedures. Coastal provinces were given greater power to approve new investment projects. This induced the increase of foreign investment in eastern coastal regions.

China has recorded rapid progress in attracting foreign investment since the adoption of its reform and open policies. During 1978-1997, the total actual used foreign capital amounted to US\$253.25 billion. Industrial projects (including processing projects) account for more than 70% of the total foreign funded projects. The increasing foreign investment

has been an important source of China's export expansion. The share of exports from foreign-funded enterprises in China's total exports increased from 1.08% in 1985 to 12.58% in 1990 and 40.72% in 1996.

**Table 4.5** *Share of Foreign-Funded Enterprises' Export in China's Total Exports*

Year	Export (US\$ bn)	Share of total exports (%)	Import (US\$ bn)	Share of total imports (%)	Export and import (US\$ bn)	Share of total exports and imports (%)
1981	0.032	0.15	0.111	0.50	0.143	0.33
1985	0.297	1.08	2.064	4.89	2.361	3.39
1990	7.814	12.58	12.306	23.07	20.120	17.43
1991	12.047	16.75	16.908	26.50	28.955	21.33
1992	17.357	20.42	26.376	32.73	43.734	26.42
1993	25.237	27.50	41.833	40.24	67.070	34.27
1994	34.713	28.69	52.934	45.79	87.647	37.04
1995	46.875	31.51	62.942	47.70	109.818	39.10
1996	61.506	40.72	75.604	54.45	137.110	47.30

Source: Long Guoqiang (1994); State Statistical Bureau (1996b, 1997b).

While the rapid growth of foreign investment and associated exports were noted, some comments are needed to demonstrate the underlying function of trade policy. First, in the early years of the reform period, foreign investment and associated exports were not as important as they have been later. The surge of foreign investment and associated exports has occurred since the late 1980s, just after a series of decentralisation programmes. Along with the opening-up process, investment and trade policies relative to foreign-funded projects were much relaxed. Regarding the foreign-funded projects, in 1985 for example, Guangdong and Fujian had rights to approve technology-introducing projects with total investment under US\$10 million. After 1988, all Sino-foreign joint-venture projects of total investment less than US\$30 million in coastal provinces and cities could be approved by the local governments if the foreign exchange payment could be self-balanced and product exports were not involvement in export quotas. In Hainan and Pudong, the kinds of projects which could be approved by local governments were even larger than in other provinces (Cheng Linzhu *et al.* 1995, pp. 41-42).

Second, foreign-funded enterprises have enjoyed some other preferential conditions in China. Before 1994, for example, state-owned trading enterprises had to complete state-assigned export earning plans. State-owned enterprises had to sell 20% of export earnings within planned export targets to state-assigned banks at the official exchange rate. But foreign-funded enterprises could retain all exchange earnings and these balances could be sold (swapped) at the swap rate which was about 3 *Yuan* higher than the official rate. This

meant that while state-owned enterprises made one dollar, they would receive 0.60 *Yuan* less than FFEs after converting foreign exchange to *Renminbi* (The Project Research Team of UIBE 1994). The dual-rate foreign exchange system ended in 1994 and there is now no mandatory plan to force domestic enterprises to hand over exchange earnings to the government. Even so, foreign-funded enterprises may still enjoy greater freedom than state-owned enterprises, since the latter are still responsible for making exchange earnings for the country and the state still has some controls on the distribution of exchange earnings.

Besides the above, foreign-funded enterprises could enjoy some other benefits from preferential policies including tax exemption, tariff-free imports and simplified approval procedures. All these endowed foreign-funded enterprises with superior conditions over domestically-funded enterprises. In other words, the rapid growth of foreign-funded enterprise exports has benefited greatly from the country's preferential policies. In this sense, preferential policies for attracting foreign investment became part of China's export promotion policies.

#### **4.5 EXPORT CONTROLS AND TAXES**

While many policies were adopted to promote exports, the Chinese authorities also employed an array of controls to manage their exports. The main measures of export control include, besides the export planning discussed in Chapter 2, export licensing and export taxes.

##### **4.5.1 Export Quota and Licensing System**

China instituted an import and export licensing system in 1980 as a part of foreign trade reform. The initial goals of the licensing system were to strengthen the administration of import and export trade under the national plan, protect the economy, stabilise markets at home and abroad, and give better economic results. By 1983, a list showed that there were about 38 kinds of export products requiring export licenses (Shen Jueren 1983). The number of commodities requiring export licences increased to 152 by 1986.<sup>[2]</sup> Among them, 19 were issued by MOFERT, 38 by the Representative Offices of MOFERT, and 95 by provincial Foreign Economic Relations and Trade Committees (*China's Foreign Trade*, No. 5, 1986). In 1989, the number of export commodities subject to licensing increased to 173

(Lardy 1992, p. 44). The trend was clear that, in the 1980s, as the scope of export plans became smaller, the range of export commodities subject to licensing became wider.

The use of export licensing has decreased in the 1990s. In 1992, export licensing was applied to 676 Harmonised System commodity groups, accounting for over 15% of China's exports (World Bank 1994a, p.68). After several adjustments, and the combination of quotas with export licences, there were, by 1993, four categories of export commodities falling into the range of quota/licensing administration, according to *The Tentative Measures of Export Commodity Management* (1993). These four categories included 138 commodities, accounting for 40.7% of China's total exports (Table 4.6).<sup>[3]</sup>

**Table 4.6 Commodities Subject to Export Quota Licensing (1993)**

Category	Number	% of total exports	Examples of commodities	Type of export control
I	38	23	Rice, soybeans, coal, crude oil, cotton	Planned export quotas
II	54	5.9	Firecrackers furfural, honey, canned asparagus	Voluntary export quotas
III	22	1.8	Bristles, bearings, general chemicals, computers, heavy water, easy-made noxious chemicals	General export licences
IV	24	10	Textile products, dried sweet potato, canned mushrooms	Negative export quotas

Source: Wang Shouwen (1994).

The first category covered those commodities related to the national economy and people's livelihood, mainly natural resources and traditional export commodities. For the export of these commodities, "planned export quotas" were applied. The second category covered 54 commodities which are leading export items but are subject to "voluntary export restraints" by China's trading partners. For this category of exports, "voluntary export quotas" were implemented. The third group covered some famous, fine and special export commodities which could easily suffer from export distortion. For these commodities, 22 in number and 1.8% of total exports, "general export licences" were required. The last kind is the commodities that were restrained by quotas of foreign countries. There were 19 textile products and 5 other products in this category. For these products, "negative export quotas" were used to arrange the exports.

In 1995, the number of export commodities subject to quota and licensing was 143.<sup>[4]</sup> The method of issuing export quotas/licences, according to a document of MOTFEC, was as follows: Of the 143 varieties of export commodities requiring licences at the time, only 21 were given export licences by the MOTFEC, 59 commodities were licensed by

representatives dispatched by MOTFEC to various localities, and the remaining 63 commodities were given licences by local commissions (MOTFEC 1994).

Since 1994, an export quota tender system has been introduced to improve the quota licensing system. In March 1994, for the first time, quotas for 13 export commodities, including crude wood, light (and heavy) magnesium, and gauze, were distributed through the new tender system. 705 of 872 distributed bidding contracts have been collected; 225 bidders won quota contracts (Reporter of *Intertrade* 1994). The export quota tender mechanism increased the degree of fairness and transparency in distributing quotas. It improved the effects of export quotas. In the mean time, exports have been achieved at higher prices. The blind price competition between enterprises has been reduced, since the enterprises have to add the cost of the quota to total export costs. In addition, in order to obtain necessary export quotas, enterprises are compelled either to develop new, high-tech and high value-added products to strengthen their competitiveness or to develop the production of non-quota products. However, the quota tender mechanism is far from complete.

Some have indicated its weakness whilst the main achievements of the system have been appreciated. Wang Shouwen (1994) pointed out that the export quota tender mechanism is still unfair, as the prices on award of bids are influenced by the bids offered by bidders. Different winning bidders may obtain the same amount of quotas by paying different prices that they originally offered in their bidding, if they won their quotas on the award of bids. In other words, different winners of the same product may be bound to different price levels. Experience has shown that the differences in prices varied by several hundred percent. Furthermore, it is also a problem that the tender system increases costs to the bidders, given there are some complex procedures to go through and some fees to pay. Wang Shouwen therefore calls for a special export tariff system to replace the tender mechanism of some export commodities. Liu Changyu (1995) criticised two aspects of the negative impacts. One is that the tender mechanism induced some enterprises to make over-high bids to obtain quotas since the availability of export quotas was effectively a precondition for enterprises to earn foreign exchange and, probably, profits. This may be harmful for some export products in the future because the high prices will lower the competitive power of export commodities. The other is that the change of winners may be unfavourable for maintaining the existing export channels.

These problems were in the implementation measures rather than the tender mechanism itself. Distributing quotas through a tender system is better than through an administrative approach. To smooth the conflicts, one effective solution would be to improve the tender mechanism, as well as to encourage enterprises to adapt to the unavoidable change. MOFTEC announced some new measure in 1995 to improve the open tender system, through the simplification of the procedures and the combination with other approaches of tender including agreement tender and directional tender (Mao Guangzhong 1995). The implementation of the export quota tender mechanism signalled the shift of export quota distribution and management from administrative manipulation to a market mechanism adjustment. It is a significant step in the adaptation of China's foreign trade regime to international norms.

#### **4.5.2 Export Tax**

Export tax was a relatively new policy used by China to control its exports. Previously, export control in China was mainly dependent on administrative forces such as export plans and/or export prohibition. The use of export taxes reflected China's intention to adjust the volume of some export commodities and improve the terms of trade by using market mechanisms. Usually these kinds of exports were those not concerning the national economy and livelihood of people. They also were those which have captured a sufficiently large market share and had a high export demand elasticity in the world market, such as raw silk, lead, raw lacquer, etc..

Between the late 1980s and mid-1990s, China expanded the use of export taxes as a supplement to the export licensing system. The product categories subject to export taxes had risen from 19 in 1987 to 54 in 1994 but was reduced to 49 in 1996 (World Bank 1994a, p. 69; *People's Daily*, overseas edition, 28/12/1996). In December 1996, China announced that it would phase out export taxes on 14 export commodities on 1 January 1997. Only 15 commodities continued with the existing export taxes. Of these 15 taxable export commodities, temporary annual export tax rates were, once again, imposed on 4 commodities including ores and concentrates of lead, zinc and tin, and zinc without forging and pressing (*People's Daily*, overseas edition, 28/12/1996).

The historical functions of tariffs, either on exports or on imports, were to raise government revenue and to protect domestic economic development. In the contemporary

world, the importance of trade-tax revenue has declined while the protective effects of trade tax has sometimes been desired in practice (Corden 1997, pp. 45-60). However, the result of using export taxes may not always be in favour of the country relying on them for the improvement of terms of trade. In contrast, it may hinder the exports of related commodities. China needs to reduce its trade restraints both in imports and exports.

#### **4.6 EVALUATING CHINA'S EXPORT POLICY REFORMS**

On the whole, China has made great effort to harmonise its export policies in accordance with international trade practice. Based on the above analysis, some characteristics of China's export policy reform can be drawn out:

First, a basic trend in China's export policy reform has been the move from strong export promotion to neutral incentives. This has been China's trade strategy over the reform period. China's overemphasis on export promotion derived from its long-lasting IS strategy which heavily biased against exports. To compensate the incentive distortion, China adopted a series of promotion measures to stimulate the growth of exports in order to increase foreign exchange earnings to facilitate the IS industrialisation. When China realised that the IS strategy was not the best way for development, trade strategy was changed again to a mixed strategy integrating the contents of the IS and EP strategies. IS industrialisation was no longer a dominant determinant of trade policies. China's export policies were then moved in the direction of neutrality with less discrimination towards both exports and imports, by reducing and eliminating the excessive export incentives.

Second, China's export policies have been turned from dependence on administrative forces to reliance on market mechanisms. In the early years of reform, administrative measures were the main forces pushing exports to grow. The FER scheme was something like a government granted "bonus" to exporters. Export subsidies were an administrative support for exporters. Through reform, especially the institutional reforms in the 1980s, trade policies have increasingly been based on the market mechanism. The change of the FER system from regional basis to product basis (1991), the relaxation of restrictions on the access to swap exchange rate (1988 and sustaining years), the elimination of export subsidies (1991), the reductions of export quotas and licensing (various years), the unification of exchange rates and the elimination of the FER system (1994), the increasing importance of the duty drawback system (since 1991) and the phasing-out of the

preferential policies toward foreign-funded enterprises (1996) all showed that administrative export incentives interventions have been gradually reduced.

Third, China's export policy reform has been a phased process composed of two major stages. In the 1980s, China gradually opened up its economy to the rest of the world while the economy was still heavily focused on an IS strategy. Export policy reform therefore concentrated on the increase in export incentives. Many export policies were aimed at compensating for the trade distortion effects of the IS strategy. All these measures played important roles in promoting exports and became major factors contributing to China's rapid growth of exports. However, each export incentive was active in a different period. Notably, the dual-rate exchange and the FER systems were the main source of export incentives and remained active until the mid-1990s. Although it was introduced into the export sector in 1985, the duty drawback system seemed less important in the 1980s due to the lack of a corresponding reform in the domestic taxation system. The export subsidy policy existed for only a few years but domestic subsidies, as in many other countries, has continued to be a part of export incentive policy.

In the 1990s, China's export policy reform entered into the second phase. In fact, when China applied to return to the GATT in 1986, Chinese leaders and economists began to consider the formalisation of the export policies in accordance with international practice. In the late 1980s, the central government reduced the role of subsidies through the implementation of the contract responsibility system in which the levels of export subsidies were fixed for enterprises. Enterprises were therefore discouraged from relying on government subsidies. In the 1990s, many measures have been carried out to regularise China's export policies. The elimination of export subsidies was the first step. Then the range of export controls like quotas and licensing were substantially reduced. Since 1994, more measures were introduced to increase the neutrality of export policy. These included the elimination of the exchange retention system (1994), the unification of the dual exchange rates (1994), the implementation of the new value-added tax system (1994), the phase-out of the preferential interest rate for export loans (1995), the end of preferential policies for foreign-funded enterprises (1996). All these measures aimed at formalising export incentives and providing a fair competition environment for both domestic and foreign-funded enterprises.



On the other hand, it is worth noting that the evolution of China's export policy has been arduous and tortuous. Two lessons can be drawn from China's experience. First, the gradual and changeable policy measures increased the cost of reform. An example is the two adjustments of duty drawback rates within half a year. There was not enough time left to allow the rates to slide down. These major reductions of duty drawback rates created an entirely different situation for exports in the second half of 1995 and the first half of 1996. To enjoy a higher duty drawback rate, enterprises made great efforts to increase exports in the first half of 1995, and once again before the end of 1995. In the first half of 1996, according to customs statistics, export declined sharply to US\$64.6 billion, 8.2% lower than the same period of 1995 (*Global Electronic Daily* 15/7/1996). On an annual basis, exports increased only by 3.3% in 1996, much lower than the growth rate of 22.9% in 1995.

Second, the lag in domestic reforms have generated difficulties for export policy reform. The fate of the duty drawback system in the past reform period is a typical example demonstrating the importance of the support of domestic reforms for trade policy adjustment. Although the intention of implementing the duty drawback system was announced and carried out in 1985, the effect of this system was very small in its first decade of implementation. The reason for this was China's lack of a comprehensive taxation system to back such a reform measure. In this regard, a World Bank report (1987) suggested that China needed to replace the consolidated industrial and commercial taxation system by a value-added taxation system that is the foundation of a duty drawback system (World Bank 1987, 1.31, 4.23). This situation lasted until 1994 when a new value-added taxation system was set up. This reflected the restraints to export policy reform due to domestic economic condition on the one hand and indicated the lack of overall blueprint for trade reform on the other. Moreover, the real reason may be the intention of some Chinese authorities to maintain the existing government control over trade policy reform, to go on enjoying the fast expanded growth of the economy and exports rather than taking the risk of trade policy changes. In fact, many delays of economic and trade reforms were attributed to such a conservative consideration.

Before the intensive trade policy reform in 1991, export promotion policies in China featured heavy subsidies, pricing controls, tax exemptions and some other administrative measures. Many of them have now been considered incompatible with international trade practice. Begun in the 1990s, China's trade policy has been shifting from strong export

promotion to moderate and neutral measures balancing exports and imports. Although further reforms are still required, after twenty years of effort, China's export policies have been fundamentally changed into a set of market economy-based instruments.

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[1] Due to different sources, the amount of subsidies cited fell in the range between 20 and 30 billion *Yuan* per year during 1987-90. Lardy (1992) estimated it as about 23 billion *Yuan*. The data in World Bank's are higher than Lardy's estimate. However, in Chinese publications the amount of foreign trade subsidies in the period are about 20 billion *Yuan*.

[2] According to a report presented by Chinese economists, the number of export commodities subject to licences declined from 285 to 133 during 1986-1994 (the period that China was applying for rejoining the GATT). See The Project Research Team of the UIBE (1995). In this thesis, I take the number from *China's Foreign Trade*, a journal edited and published by the trade authority (MOFERT, now MOFTEC) because most other figures used in this section are directly or indirectly from the MOFTEC sources.

[3] According to the World Bank, 38 broad categories of products still remain subject to export quotas/licenses in April 1993. See World Bank (1994a), p. 68.

[4] According to the MOFTEC (1994), the number of export commodities subject to quota and licensing would be 114, taking in effect since 1 January 1995. For the convenience of management operation, these 114 commodities had been further classified into 143. Therefore, I use the number 143 as the total number of export commodities subject to quota and licensing in 1995.

## **5 Liberalising Import Policies**

In the initial stage of the opening-up process, imports and exports were under state control. To balance foreign trade, China was used to controlling import volume to maintain a favourable balance of payments. By the late 1980s, China's foreign trade changed in the face of market regulation. More autonomous rights to trade have been granted to trading enterprises. Trading enterprises were allowed to decide when and how to use their retained foreign exchange for imports according to market signals. The change of import rights from state control to enterprise autonomy reflected the trend of import liberalisation in China. The method of macro-control over foreign trade has been shifting from being predominantly administrative measures to being mainly economic policy instruments. Import policy reform is becoming an increasingly important ingredient of trade reform.

### **5.1 TARIFFS**

#### **5.1.1 The Use of Tariffs in the Chinese Economy**

Tariffs, which refer to the taxes levied on imported or exported products (popularly, tariffs on exports are usually called export taxes), are usually used as one of the important policy instruments. Import tariffs and export taxes, given their transparency based on market mechanisms, are regarded as better instruments than quantitative restraints for adjusting trade flows (Greenaway and Milner 1993, p. 64). In most countries, the focus on export promotion actually leads to the minimum use of export taxes. In the international trading system, therefore, attention is concentrated on tariffs.

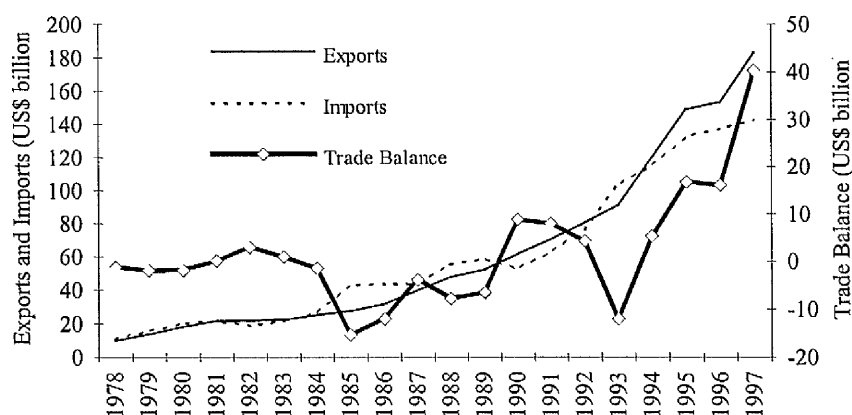
As mentioned earlier, generating fiscal revenue and protecting the domestic economy are two major functions of tariffs. In the Chinese economy, tariff policies have long been emphasised as instruments of economic adjustment rather than as a source of government revenue. Basically, the use of tariffs in China so far has involved the following three aspects: trade balance, export promotion and trade liberalisation.

### *Tariff and Trade Balance*

China has implemented an IS strategy for a long time. The role of tariffs in the inward-looking regime was redundant, since all imports were controlled by state plans. The only function of tariffs in the pre-reform era, though small, was as being a source of government revenue. Even in 1980, two years after the beginning of the reform and opening process, collected tariffs brought in 3 billion *yuan* in government revenue (Qiu Deming 1982).

Since 1980, while the opening-up of the economy induced a rapid growth of trade, trade deficits were not unusual in China. A greater importance was attached to the use of tariffs in adjusting the volume and commodity composition of both exports and imports. With the decentralisation of import rights, and the backdrop of an overheated domestic economy, imports fluctuated up and down throughout the reform period. Imports peaked in the years 1984/1985, 1988 and 1993. Some smaller increases showed in the years of 1981, 1986/1987 and 1989/1990. Trade deficits were not very severe before 1984 but worsened in 1984-1990 and again in 1993.

**Figure 5.1 Trade Balance, 1978-1997**



Source: IMF(1995); State Statistical Bureau (1996b, 1997b); *Wen Wei Po* 12/1/1998.

Controlling the volume of imports was a basic way to balance import and export trade. As shown in Figure 5.1, during 1978-1997, trade deficits were recorded in ten years out of the total twenty years. Among them, nine occurred before 1990. Based on the trade balance policy, the volume of imports was thought to be restricted. Traditionally, China's import control relied very much on the use of administrative forces. However, high tariffs were also used as an instrument to help balance trade flows. In particular, tariffs on imported

consumer durables, such as television sets, electronic calculators, radio/video recorders, motorcycles and cars, were raised sharply to control the volume of these imports. Tariff rates were in fact adjusted frequently after 1980, beside two large adjustments in January 1982 and June 1987. In July 1985, China introduced an adjustment import tariff (“regulatory import duty”) to restrict the increasing imports of some commodities. Tariff rates have become more important determinants of the volume and composition of commodity imports and have fluctuated over time. By 1986/1987, China’s unweighted average tariff rate in 1986 was 38.1% and the weighted average tariff rate in 1987 was 29% (Dean *et al.* 1994). Even in the 1990s, high tariffs on consumer durables were not the targets of tariff reductions.

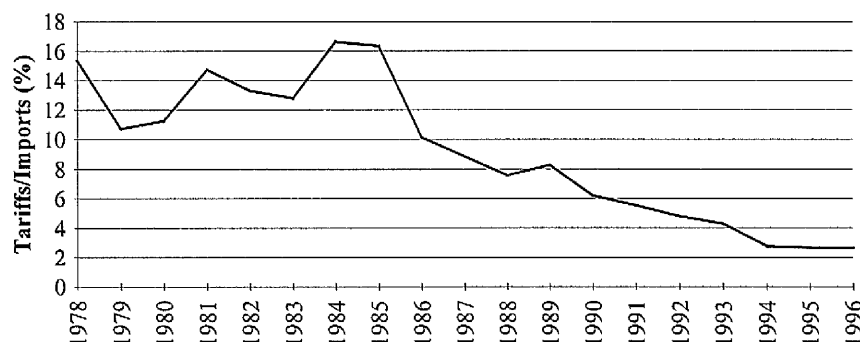
### ***Tariff Exemption***

While the imports of consumer goods were tightly restricted in China’s tariff system, the imports of production facilities received a very different treatment. This was fully reflected in the policies toward foreign investment in China. Encouraging the development of foreign-funded enterprises in order to expand exports was an important ingredient of China’s export promotion policy. Foreign-funded enterprises could enjoy many preferential policy measures, including tax reduction or exemption, tariff-free imports, simplified approval procedures and other benefits. Besides foreign-funded enterprises, many domestic enterprises involved in export activities could also enjoy tariff exemptions.

Most preferential policies were implemented first in SEZs and ETDZs. With regard to the implementation of duty exemption, the main categories which benefited were: (1) Machinery and equipment, and other materials imported for the infrastructure facilities within SEZs and ETDZs; (2) Equipment imported by foreign-funded enterprises for investment; (3) Materials and equipment imported for inward processing including “inward processing with supplied materials” (*Lai Liao Jia Gong*) including “inward assembling with supplied parts” (*Lai Jian Zhuang Pei*), “inward processing with imported materials” (*Jin Liao Jia Gong*) as a form of “processing according to buyer’s samples” (*Lai Yang Jia Gong*) and “compensation trade” (*Bu Chang Mao Yi*);<sup>[1]</sup> (4) Export products processing domestically supplied materials, and with 20% and over value-added in SEZs and ETDZs, can also be exempted from export taxes (Lin Hanchuan 1993; World Bank 1994a, pp. 58-60). These tariff exemptions, to different degrees, were extended to other open cities and areas, and to

other trade forms (for example, border trade could enjoy a 50% tariff concession) in the period between mid-1980s and before 1994.

**Figure 5.2 Collected Tariffs as a Percentage of Imports**



Source: State Statistical Bureau (1996a, 1997b).

The preferential tariff policies adopted led to China's real tariff rates being much lower than nominal tariff rates, due to an extensive system of import duty exemptions and rebates designed to promote exports. As shown in Figure 5.2, the actual tariff rates (collected tariffs/imports) were in a range between 10-16% during 1978-1986, very close to the average tariff level of the developing countries. Since the mid-1980s, this tariff ratio to imports has continuously declined to about 3% in the mid-1990s. This reflected an unsuitable deviation between tariff policy and the results of implementation.

### 5.1.2 Tariff Policy Reforms

Prior to the tariff policy adjustment in 1996, China's tariff system was self-contradictory. Compared with the average levels of developed and developing countries, China's nominal tariff rate was very high. However, to stimulate foreign direct investment (FDI) inflows and the imports of advanced technology, various tariff exemptions were applied to a great range of imports. In such circumstance, China gained less tariff revenue than would be consistent with the nominal tariff rate, although it was frequently criticised for its high tariff protection. To correct these distortions of the tariff system and, further, to liberalise the whole import system, China has taken a series of measures to cut the tariff rate and to adjust its FDI policies. Through reforms along these two lines, China's tariff system has been moving towards a normal pattern based on the market economy.

### *Tariff Reductions*

Prior to 1991, the trend of tariff rates seemed to increase the average rate of protection. As a result, China's tariff rates remained at relatively high levels. A possible explanation is that China tried to shift some non-tariff import barrier protection to tariff restriction, given that many administrative measures for controlling imports were abolished in the process of decentralisation. Since 1991, however, China has launched a series of tariff cuts, due partly to the further opening-up of the economy and partly to the pressure from other countries.

At the start of the series of consecutive tariff reductions, China reduced the tariff rates on 265 import commodities of 43 tariff lines in 1991 (*People's Daily* 16/11/1993, 17/11/1993; Fan Baoqing 1994). Subsequently, tariff reductions were seen in the sustaining years from 1992 through 1997 (at the time of writing this thesis).

On 1 January 1992, a sizeable reduction of 225 tariff lines was implemented. According to GATT's estimate, these items accounted for 4.4% of China's total import tariff lines at the time (World Bank 1994a, p. 49). Moreover, in April 1992, all regulatory tariffs were revoked and the tariff rates for video cameras and cars were also adjusted, in accordance with the decision of the Customs Tariff Commission (CTC) of the State Council. With the cancellation of the regulatory duties, the actual tariff burden for 16 categories of import commodities was reduced in scope from 28% to 61.5% (*People's Daily* 15/3/1992). Another tariff reduction was introduced on 31 December 1992. The reduction involved 3,371 import commodities, accounting for 53.6% of all items covered by customs import tariffs (*Beijing Review* 21-27/12/1992). Among major commodities affected by the reduction were (1) raw materials which China has been importing for a long time, (2) advanced products which China lacked the technology to produce, (3) some products made in developing countries, and (4) some products in which China was highly competitive on world markets.

In November 1993, the General Customs Administration (GCA) announced that China would lower import tariffs as from December 31, 1993. The reduction involved 2,898 import commodities which included some raw materials in short supply in China, and equipment in great demand. In addition, the duty rates on some articles, permitted to be carried to the country by tourists and goods sent from abroad were also lowered. These commodities covered about half the country's import items (*People's Daily* 16/11/1993, 17/11/1993). The reduction meant that the average rate of China's customs duty was lowered

by 8.8%. The average tariff rate (unweighted) decreased from 39.9% to 36.4% (*People's Daily* 16/11/1993, 17/11/1993).

Almost at the same time as the reduction at the end of 1993, on 1 January 1994, the Customs Tariff Committee of the State Council decided to reduce the tariff rates for imported cars and impose temporary tariff rates on 234 import commodities. The rates for imported cars with gasoline engines less than 3,000 millilitre exhausts and cars with diesel engines less than 2,500 millilitre exhausts were reduced from 220% and 180% to 110%. The rates for cars with gasoline engines over 3,000 millilitre exhausts or with diesel engines over 2,500 millilitre exhausts were lowered from 220% to 150% (*People's Daily* 2/1/1994). The temporary lowering of tariff rates was extended to some imported metal raw materials, chemical materials and products, agricultural materials, and components and parts of machinery and electronic products for one year (1/1-31/12/94).

On 1 July 1995, China adjusted the preferential import tariff rates on video tapes and minibuses (10-29 seats), while the nominal tariff rates remained unchanged. At the end of 1995, the State Council announced a sizeable tariff reduction which was implemented from 1 April 1996. At this time, China had 6,265 tariff lines. This reduction affected more than 4,000 tariff lines, accounting for about 64% of all items covered by customs tariffs. With this reduction, China's tariff level (unweighted average tariff rate) fell from 35.9% to 23%, with a decrease in tariffs of about 30% (*China's Foreign Trade*, No. 4, 1996; *China's Scholars Abroad*, electronic edition, 12/4/1996). The concentration of the reduction was still, as before, on the imports of important raw materials, agricultural products, advanced technological equipment, and goods in short supply in domestic markets.

The latest tariff reduction took place on 1 October 1997. According to the Customs Tariff Committee of the State Council, this tariff reduction involved 4,800 commodities, covering more than 73% of existing tariff lines. Through this reduction, China's average tariff rate would decrease by 26%, from 23% in 1996 to 17% in 1997 (*China's Scholars Abroad*, electronic edition, 19/9/1997). Chinese leaders announced that China would take effective steps to further reduce customs tariffs to the average level of other developing countries (*Beijing Review* 29/4 - 5/5/1996).



**Table 5.1 Changes of China's Average Nominal Tariff Rate****(%)**

	Average nominal tariff rate	Items of tariff reduced in the year
1950-1984	52.9	
1986	38.0	-
1990	42.5	-
1991	47.2 down to 42.8	265
1992	42.8 down to 39.9	225 in January, 16 in April and 3,371 in December
1993	39.9 down to 36.6-36.4	2,898
1994	36.6-36.0	234
1995	36.6-35.9	4
1996	35.9 down to 23.0	over 4,000
1997	23.0 down to 17.0	4,800

Note: For some years, tariff rate data provided by Chinese writers are variable. In this table, the differences of the various data are considered as a range of the tariff rates in the years (1993, 1994 and 1995).

Source: Dean *et al.* (1994) for 1986; World Bank (1994a) for 1992; Xu Yu and Ma Lijun (1996), Feng Cuncheng (1996), Pei Changhong (1996), Jiang Xiaojuan (1996), Lin Guijun (1996), *China's Foreign Trade* (No. 4, 1994), *People's Daily* (16/11/1993) and *China's Scholars Abroad* (electronic edition, 19/9/1997) for the remaining years.

Through several tariff reductions and the phase-out of tariff exemptions, China's tariff system has effectively been set on the right track. Although the present average nominal tariff rate is still high, a general decline of 30.2 percentage points in the average tariff rate (Table 5.1) was realised within a period of less than seven years (1991-1997). Taking account of the 1997 tariff reduction, China's average tariff rate has already moved close to that of developing countries.

### ***The Elimination of Preferential Tariff Policies***

In recent years, China has taken some measures to narrow the gap of policies granted to state-owned and foreign-funded enterprises. In 1993, the rights of foreign-funded enterprises to import tariff-free transport vehicles and office equipment were eliminated. After a short period of amortisation, in 1994, the tax system reform was rapidly extended to foreign-funded enterprises. In the newly unified tax system, both foreign-funded and domestically-funded enterprises are treated equally. In 1995 China introduced a deposit system for tariff collection on the imports of raw materials imported by foreign-funded and process enterprises. From 1 April 1996, the preferential policy which had allowed tariff-free imports of machinery and equipment by foreign-funded enterprises was eliminated (Zhu Wehui 1996b). At the same time, China has made efforts to improve the environment of investment for foreign investors by providing them with national treatment. Some economic sectors, such as retail commerce, banking and insurance, are being gradually opened up to foreign investors. The unification of the dual-rates exchange system has

basically met the requirement of foreign-funded enterprises to balance their earnings and expenditures in terms of foreign exchange.

When the 1996 tariff reduction was launched, China also declared that its import policies would be further reformed. In its *Circular on Reforming and Adjusting China's Import Taxation Policies* (1996), the State Council pointed out that some preferential tariff policies, mainly formulated at the end of the 1970s and the 1980s, no longer conformed to common international practice and the principle of equal competition under the market economy. It also argued that China must further reform and readjust its tariff policies, if it is to participate in international competition and international economic co-operation in a more open manner (*Beijing Review* 5-11/2/1996).

The main target of the tariff policy adjustment is to cut down the distance between legal and actual tariff rates. According to the State Council's notice, tariffs and import taxes would be levied on imported equipment and raw and semi-finished materials in accordance with the legal tax rates, beginning on 1 April 1996. The main measures include: (1) newly-approved foreign-funded enterprises are subject to tariffs and import taxation on equipment and raw materials imported as a part of their investment; (2) newly-approved technical transformation projects are subject to tariffs and import taxation on their equipment imports; (3) key construction projects approved by the State Council are subject to tariffs and import taxation on their equipment imported; (4) tariffs and import tax must be levied for all equipment imported by special zones including SEZs and Pudong area; and (5) the provision concerning the exemption of tariffs and import tax as for barter trade and economic and technological co-operation projects with peripheral countries are cancelled. The circular also noted that in line with related stipulations of international conventions, and in reference to common international practices, some regulations on import tax reduction and exemptions will be retained and readjusted (Huang Bian 1996).

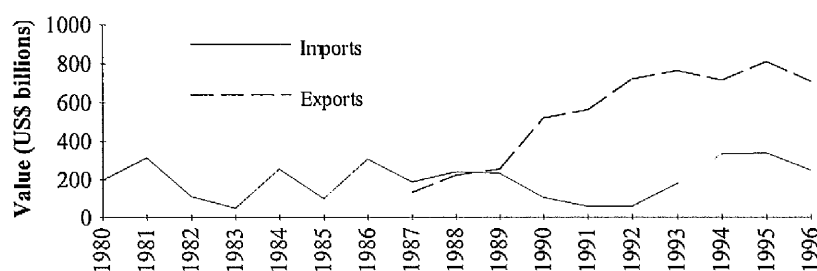
### **5.1.3 The Economic Analysis of China's Tariff Policies**

#### ***The Effects of High Tariffs***

Prior to the intensive tariff reductions in the 1990s, China adopted a policy which featured high nominal tariff rates and massive tariff exemptions. The effects of this high tariff policy were as such that follows.

First, given the structure of the tariff rates and the implementation of tariff exemptions, this high tariff policy aimed at restricting the import of consumer goods and some other imports. For the imports not enjoying tariff exemptions, high tariffs have proved a major obstacle. For example, the imports of television sets in 1980s were heavily influenced by the high tariff rate, and administrative control as well. The nominal tariff rate for imported television sets was set at 80%. The implementation of the “regulatory tariff” in 1985 imposed another 70% tariff on imports of television sets. The implicit import tariff rate therefore was as high as 150%, about twice the average rate of import tariff.

**Figure 5.3 Imports and Exports of TV Sets**



Source: State Statistical Bureau (1992, 1995); State Planning Committee *et al.* (1997).

High tariff restricted the imports of television sets and, together with other measures, provided high protection for import substituting production in China. Consequently, production of television set was rapidly developed and, since the late 1980s, television set have gradually become one of the main export products. As can be seen in Figure 5.3, TV imports declined in 1981-83, due to administrative controls. The introduction of the “regulatory tariff” in 1985 led to an obvious decrease of imports. China had no exports of TV sets before 1986. Through a decade of substitution effort in the 1980s, TV set exports grew rapidly while imports kept declining. In 1989, China for the first time had net exports of TV sets. However, in 1992 when the “regulatory duty” was eliminated, TV set imports began to increase. This proved that high tariffs on TV sets have had effect in restricting the imports and in protecting import substitution production.

Second, high tariffs have influenced domestic prices. In conventional tariff theory, tariffs levied in a large country may drive down the relative world price of imports or raise the domestic price, or have both of these effects. However, with regard to the size of imports, China was not large enough to affect the world prices in most imported

commodities. So the effect of high tariff on prices was to raise domestic prices. In 1990, for example, most domestic selling prices of imported commodities were higher than the market prices of domestic products. This situation still existed for some imported intermediate products even where their tariffs had been reduced. For example, the import price including tariffs for rolled steel (small size) was 1,916 *Yuan* per ton. Its actual import cost was 1,696 *Yuan* per ton, taking account of 220 *Yuan* tariff reduction. It was sold in the market at a price of 1,798 *Yuan* per ton, 298 *Yuan* higher than the price of the same product produced domestically (1,500 *Yuan* per ton). Consequently the domestic price went up. In fact, many imported commodities had the same effect, inducing an increase in the domestic prices. Such a situation had been a determining factor in the decision to reduce tariffs on 40 import commodities in 1991 (Huang Yaohua and Wang Zhengxiao 1991).

The price changes induced by imposing a tariff on imports would generate various welfare effects for the tariff-levying country. But, due to the lack of detailed data (especially the prices of imported and domestically-produced commodities), it is difficult to estimate the aggregate welfare effects of China's high tariff policy. However, what is certain is that China's high tariffs have led to quite large losses in consumer welfare, given that import demand has been restricted.

Third, while import demand was restricted by high tariffs, foreign competition was in fact excluded from or minimised in the domestic market. Domestic enterprises were discouraged to improve productivity, because the high tariff policy actually granted a large proportion of the domestic markets to them. The consequence was that they enjoyed the increase of producer surplus brought by the high tariff policy but contributed less to the improvement of consumer surplus.

### ***The Effects of Tariff Exemptions***

Tariff exemptions may function as incentives to encourage certain government-targeted economic activities. The use of tariff exemption to provide preferential conditions for the favoured industries or enterprises is not uncommon in developing countries where high nominal tariffs are usually present. In the case of China, tariff exemption, which was used extensively in the reform period, has been an important factor contributing to the

improvement of productive conditions and the increasing inflows of foreign investment, as well as to the decline of government revenue.

First of all, for the purpose of industrialisation, China has long been encouraging the introduction of advanced equipment and technology from the western countries. Tariff exemptions, either partial or total, were in most cases granted to the imports of productive facilities. China's industrial production has a considerably high dependence on the imports of raw materials and equipment. During 1990-1992, for example, imports of machinery and equipment became an important source of production expansion in some industrial sectors (Table 5.2). The ratio of imported supplies accounted for 53.2% in the heavy industries in 1991.

**Table 5.2 Sectoral Ratio of Dependency on Imports (1990-1992)** (%)

	Imported equipment as percentage of newly purchased equipment in the period	Imported intermediate products as percentage of all intermediate products used in the period
Chemical industry	92*	20-30
Car making industry	81	57
Steel and iron industry	71	20-30
Construction industry	59	20-30
Textile industry	38	11

\* Value of single item over 50 thousand *Yuan* (equals to about US\$9.6 thousand).

Source: Xu Kangning (1994).

In Chapter 3, the author's estimation (Table 3.2-b) has shown that the introduction of productive facility remained the main feature of China's import structure in the reform period. Given such an import structure, in which more than 80% were productive facilities, tariff exemptions were applied to a very wide range of imports. Encouraged by the tariff exemption policy, most industries and enterprises took imports of productive facilities as a way to improve productivity. Increasing quantities of raw materials and equipment were imported to support domestic economic development and exports.

Second, apart from the technological upgrade of the existing industries, tariff exemptions were also granted to the imports related to exports, providing that the imported materials were for re-export. The rapid development of processing trade has benefited greatly from the preferential treatments of tariff exemption. Table 5.3 shows the rapid development of processing industry in China during 1991-1996. The value of processing trade doubled from US\$57.49 billion in 1991 to US\$146.61 in 1996, accounting for 50.6% of the national

total trade. These tariff exemptions, in this case, acted as incentives encouraging the development of low-level labour-intensive industry.

**Table 5.3** *Share of Processing Trade in China's Foreign Trade, 1991-1995* (US\$ billion; %)

Year	National foreign trade			Processing trade			Share of processing trade		
	Exports	Imports	Total	Exports	Imports	Total	Exports	Imports	Total
1991	71.84	63.79	135.63	32.46	25.03	57.49	45.1	39.2	42.4
1992	84.94	80.59	165.53	39.61	31.51	71.12	46.6	39.1	42.8
1993	91.74	103.96	195.70	44.44	36.16	80.60	48.4	34.8	41.1
1994	121.01	115.61	236.62	56.97	47.57	104.54	47.0	41.1	44.1
1995	148.77	132.08	280.85	73.70	58.37	132.07	49.5	44.2	47.0
1996	151.06	138.84	289.90	84.33	62.28	146.61	55.8	44.9	50.6

Source: State Statistical Bureau (1996b, 1997b); Yang Shenming *et al.* (1996); *Beijing Daily*, 7/2/1997.

Third, still another goal of the tariff exemption policy was to provide preferential conditions for foreign investors in China to increase exports. These preferential conditions were helpful in attracting foreign investment. As already shown in Chapter 4, China has successfully attracted a large amount of foreign investment over the past reform years. Foreign-funded enterprises have made important contribution to China's export growth.

Fourth, the extensive use of tariff exemptions has resulted in large government-revenue loss. Figure 5.2 in the earlier part of this chapter shows that China's actual collected tariff only was a small part of the nominal tariffs in the 1990s. Concessional imports accounted for 85% of total imports in 1995 (Zhang Erzheng 1996; Jiang Xiaojuan 1996). The loss of tariff revenue (nominal tariffs minus actual collected tariffs) amounted for 93.5 billion *Yuan* (US\$19.56 billion) in 1990 and increased to 371.3 billion *Yuan* (US\$44.47 billion) in 1995. However, this is only a part of the story. Considering the fact that many state-owned enterprises operated on loss-making basis, the government could only collect a reduced amount of domestic taxes and had to spend a large amount of government subsidies on loss-making enterprises. Such multiple fiscal losses, though not all, should be attributed to the tariff exemption policy.

Finally, given China's high tariffs in previous years, tariff exemptions were certainly measures to relax import controls. However, China's implementation of the tariff exemptions had been biased in favour of productive facilities. While most imports of productive facilities were granted tariff exemption, the nation's tariff structure has in fact been changed. It is worth noting that when intermediate goods enjoy lower tariff rates than

final goods, effective rate of protection can exceed statutory rates by a multiple (Dornbusch 1992). In China, the nominal tariff rates for producer goods had already been lower than that of consumer goods. Tariff exemptions further amplified the difference between tariff rates on intermediate goods (producer goods) and final goods (consumer goods). This meant that the effective protection has been strengthened. Although it is difficult to estimate the extent to which tariff exemptions contributed to the increased effective rate of protection in China's case, the protective function of the tariff exemption policy should be noted.

The importance of the policy change is that both domestically funded and foreign-funded enterprises are now encouraged to compete and seek joint development under equal conditions, rather than using preferential policies only to attract foreign capital. The reform of the Chinese tax system and the rationalisation of FDI policies are important steps bringing the economy into conformity with common international practices.

### ***The Effects of Tariff Reductions***

Tariff reductions have been the major measures taken to reform the import system in China in the 1990s. Further, in 1996, tariff reduction was combined with the elimination of preferential tariff policies. China's reform of tariff policies has produced some positive effects on trade expansion and represent a significant move towards trade liberalisation. .

First, tariff reduction stimulated the growth of imports. For example, China's imports increased from US\$53.35 billion in 1990 to US\$132.08 billion in 1995. The average annual growth rate of imports during 1990-1995 was 19.9%, 6.5 percentage points higher than that of the 1980s (13.4%). It was at least true for those importers not enjoying tariff concessions, that tariff reductions have helped in reducing the cost of imports. In this sense, tariff reduction could be regarded as a useful measure in favour of introducing foreign technology and productive resources to improve the country's industrial structure and production capacity.

More importantly, for China, imported raw materials and intermediate products have become a pillar supporting fast economic growth. Tariff reductions were certainly a factor stimulating the increase in imports. Table 5.4 shows the increase of imports of some tariff-reduced commodities. At least it can be considered that the government was intending to let

more imports in through tariff reduction in order to supplement domestic supply (*People's Daily* 1/1/1994).

**Table 5.4 Imports of Some Tariff-reduced Commodities**

(US\$ millions)

	1990	1993	1994	1995
<b>Crude oil</b>	423.81	2323.41	1573.40	n.a.
<b>Synthetic fibre</b>	554.42	723.45	972.21	1315.94
<b>Wool and wool top</b>	280.00	701.92	793.97	944.14
<b>Rolled steel</b>	2,508.13	n.a.	8533.32	6511.22
<b>Copper and copper alloys</b>	102.65	n.a.	224.22	406.44

Source: State Statistical Bureau (1992; 1996a, 1996b); Editorial Board of *Almanac of China's Foreign Economic Relations and Trade* (1996).

Second, China's tariff reductions should be regarded as part of the effort to establish a fair, formalised and rationalised tariff system. China's tariff system has long been a distorted system. It is notable that in the 1990s greater attention has been paid to the normalisation of import policies. The adoption of the Harmonised System (HS) and the significant reductions of tariff rates since 1992 have demonstrated China's intention to formalise its trade policy in conformity with international trade practice.

China's sustained adjustments of tariff policies in the 1990s were due to the following two factors. The first concerned the decision to join the GATT/WTO. China has been required to lower its high tariffs (and other trade barriers as well) to meet the entry conditions. The second was that China needs to establish a fair competition environment for enterprises, given the goal of economic transition from planned economy to market economy. Excessive tariff protection has caused negative effects for the economy. Some backward industries were heavily protected by high tariffs and non-tariff barriers. Furthermore, if foreign-funded enterprises entered the protected industries, they also became the objective of protection (Hou Xilin and Xi Fengru 1996). Such foreign-funded enterprises have benefited from both receiving tariff concessions and enjoying tariff (and non-tariff) protection. To correct the distortions in the tariff system, China's tariff reductions have intended to follow the principles of (1) speeding up the development of foreign trade, encouraging the competition of enterprises on an equal footing and bringing into full play the macro-control function of tariffs; (2) rationalising the relations between speeding up economic development and protecting national industries; and (3) adjusting the tariff burden on different commodities in accordance with industrial policies of the country (*China's Foreign Trade*, No. 5, 1993, pp. 10-11). Given the several tariff reductions and the



elimination of the preferential tariff policies in recent years, China's tariff system has been becoming one, with lower protection and discrimination, compatible with the international practice.

Third, on the other hand, the significance of China's tariff reduction should not be overemphasised. One reason is that China's tariff rate is still much higher than the average rate of developed countries (4.7%) and even that of developing countries (13-14%). China's tariff reductions have only shown a relative decrease in tariff protection. Besides tariffs, there are still many non-tariff barriers to be reduced. Another reason is that China's high rate of nominal tariff was only of superficial significance before the elimination of preferential policies in 1996. Given the low rate of actual collected tariff (6.1% in 1990 and 2.6% in 1996, for example), China has in fact had sufficient capacity to reduce its tariff rate to a lower level. The reasons that the possible further reduction of tariff has not been taken place were probably due partly to the imperfection of a tariff system based on a market economy, and partly to the country's strategic and political considerations. For example, China's status in the WTO may be one such consideration.

On the whole, tariff reform has played an important role in China's trade policy liberalisation. This can be shown through the following features of reform. First, the extent of tariff reductions was very large in the 1990s, involving a total decrease of 30.2 percentage points in the average tariff rate. Second, the elimination of preferential policies enabled the nominal tariff rate to become functional. Although it means that China's average tariff rate may be restored to a higher level, China's announcement promising to reduce its tariffs to the level of developing countries (13-14% at present) within a few years could be an equivalent measure of trade liberalisation. What can be appreciated is that China may establish an undistorted tariff system through such a reform. Third, the tariff reductions in 1996 and 1997 have placed an emphasis on the liberalisation of manufactures imports instead of focusing on raw materials and intermediates as in previous reductions. This has been consistent with the trend of trade liberalisation in other parts of the world. Liberalised manufacturing imports and the corresponding increase of competition will press China's enterprises to improve their productivity.

## 5.2 NON-TARIFF MEASURES

Non-tariff measures used in China to restrict imports included mandatory import plans, canalisation of imports through designated national FTCs, foreign exchange allocation, import licensing and quotas, and other import controls. After almost 20 years of reforms, China's trade system has moved from a strictly controlled regime to a much freer one, where the role of planning has been much diminished, the exchange rate system has been unified, and other import controls have been greatly minimised. However, China's import regime is far from completely liberalised. Some non-tariff barriers are still actively used to regulate imports.

### 5.2.1 Import Licensing and Quotas

#### *Using Import Licences and Quotas in China*

China introduced an import and export licensing system in October 1980 and formalised the system in state regulation in January 1984 (Wang Shizhen 1990). On the side of import licensing system, all imported goods were divided into restricted and unrestricted categories. The number of restricted categories was 13 in 1980, increasing to 53 in 1988., The number 53 remained until 1993. Besides the requirement for import licences, quotas were applied to some import commodities.

**Table 5.5** *Number of Imports (commodity group) Subject to Licensing (1980-1996)*

	1980	1983	1984	1985	1986	1987	1988	1993	1995	1996
Commodities subject to import licence	13	18	28	45	42	45	53	53	36	36

Source: Shen Jueren (1983); *China's Foreign Trade*, No.5, 1986; Garnaut and Huang (1995), p. 9; Xue Rongjiu (1995); The Project Research Team of Peking University(1996); Lin Guijun (1996); Li Dongsheng (1997).

Of 53 commodity groups subject to import licensing in 1992, the starting year of China's intensive trade policy reform, two-third were planned to be reduced in the following period of two or three years (Liu Xiangdong 1992). A timetable was set up for the decrease in the scope of import licences, eliminating 12 (groups of) import licences by the end of 1993, 23 by 1994, 9 by 1995, 2 by 1996, and the remaining 7 thereafter (Tong Jiadong 1994). Looking at the practice, 283 tax items were exempted from quotas and licence at the end of 1993. In June 1994, quotas and licences were cancelled for 367 import commodities (Meng Xiangang 1997). The actual result by 1995 was that, however, 36 commodity groups were still subject to import licences (Table 5.6). This meant that the proposed target of licence elimination was not completed.

**Table 5.6 *Import Controls, July 1995 (quotas, licences and automatic registration)***

Import control measures	Commodity groups covered	Commodity varieties in the group
Quotas plus licences	31	301
General goods	16	133
Machinery & electrical products	15	168
Licence only	5	53
Automatic registration	20	574

Source: MOFTEC, quoted from Lin Guijun (1996).

In 1996, China announced to remove licence and quotas requirements on 176 varieties of import commodities, or 30 % of all items subject to import quotas and licences, effective from 1 April 1996 (Lin Guijun 1996). Partly as a result of this, three commodity groups were taken off the list of quota control system (but still subject to licensing). Therefore, in 1996, there were 28 commodity groups subject to import quotas plus licences while 8 commodity groups were subject to licensing. The total number of commodity groups subject to import licensing remained 36 (Li Dongsheng 1997). The varieties requiring import quotas and licences were reduced from 1247 in 1992 to 384 in 1997, accounting for only 5% of total tax items of imports (Meng Xiangang 1997).

Liberalisation measures have improved the conditions of access to China's market. However, although the scope of import quotas and licensing has been significantly reduced, establishing an effective system for distributing quotas and issuing licences in the remaining areas still remained a problem for Chinese trade authorities. After the 1996 reduction, for example, quotas and licences for the 36 groups import commodities were separately issued by several departments including the State Planning Committee, the State Office for Mechanical and Electrical Industry and many other ministries (Li Weicheng 1997). This situation very often generated conflicts and made for less transparency in quota and licensing distribution. Nonetheless, the progress in reducing import licensing at least demonstrated China's move towards liberalisation.

### ***The Significance of the Reforms in Licensing and Quotas System***

The initiative of the quota/licensing system was to strengthen the administration of import and export trade under the national plans, to protect the economy, and to stabilise markets at home and abroad (Shen Jueren 1983). With the progress of trade reforms towards the normalisation of trade policy, the system has been used to replace trade plans as the principal instrument of trade controls.

However, China's adoption of the licensing system could be regarded as a step towards standardising and legitimating its trade control system, required for the establishment of a market economy in the country. In a market economy, controlling imports using import licences and quotas can be regarded as a step away from free trade toward more managed trade. But in an economy in which a planned import control system has long been applied, such as in China, the adoption of a licensing and quota system should be considered as a transition step in the transformation of a trade regime with tight restrictions to one with greater freedom on imports.

In the literature of trade policy reform, a common recommendation is to convert non-tariff measures into tariffs, to enhance the transparency in trade policies. In the same spirit, converting planning control over imports into licensing and quota system is also a necessary step leading trade policies back to common forms used in other countries. Then other reform measures can be carried out one after another to move towards liberalisation. The licensing and quota system is more transparent than mandatory plans. In China, licensed commodities and license application processes were publicised in newspapers (Fan Baoqing 1994), and computers have been used to assist with the management of licence distribution, through a network linking the Customs and the Bureau of Foreign Currency Control run by the MOFERT (Xu Jianya 1994). These measures have effectively reduced the opportunities to distribute licences illegally.

Imposing licensing requirements and quotas on imports may have the same effects of restricting trade and the associated welfare losses caused by tariffs in the importing country. More importantly, unlike tariffs which rely on the price mechanism, the licensing and quota system provides more places where government administrative forces remain active to control imports. In the case of China, the use of import licences and quotas was aimed at controlling the domestic prices to protect domestic industries. As already noted, the size of China's imports could not influence world prices. Import licensing and quotas were used as measures to prevent decrease of domestic price due to the increases in imports. With the restrictions of licensing and quotas, a large proportion of restrained demand could only be met with higher-cost domestic production instead of lower-cost imports. The consequences were of cause the losses of allocative efficiency and consumer welfare.

In view of the fact that licensing and quotas have been widely regarded as harmful protection measures, China has taken steps to reduce the scope of license-and-quota-controlled imports. It has also been required for China to make its foreign trade control system meet the fundamental rules of GATT/WTO and the general standards of world trade. In 1986, the major non-tariff measures including import licences, import quotas, import plans and import controls covered 80% of total imports (Wu Jiahuang 1996). By 1992, the coverage of non-tariff barriers on imports dropped to about 51.4% of total imports (World Bank 1994a, P. 63; Sheng Bin 1994). After 1992, as was mentioned above, some further reform measures, including two reductions of import quotas and licences in 1994 and 1996, were taken to reduce non-tariff barriers.

Like tariff reduction, the decreasing use of quantitative measures also contributed to the growth of imports, improvements in trade structure and the development of the economy. However, the more significant contribution of the removal of quantitative restraints has been the improved conditions for the establishment of a new system of trade policies based on market mechanisms. Reducing the use of import quotas and licences has shown China's confidence in using the market mechanism (tariffs, exchange rate and resulting price changes), rather than administrative controls, to adjust import flows. Undoubtedly, the trend for China's import licensing system is to be reduced in the future. How it will be done depends on the progress of China's trade regime reforms, especially on the shift of macro-control mechanism of the trade system from administrative control to an overall regulation and control by means of tariffs, exchange rates, credit, and interest rates.

### **5.2.2 Foreign Exchange Control**

#### ***Exchange Rate***

The exchange rate under the IS regime was actually in favour of imports, due to the overestimation of the domestic currency. Since reform, China's exchange rate has been frequently adjusted, in both official rates and the use of "swap" rates. With the depreciation of the *Renminbi*, China's exchange rate has moved to a relatively realistic level. Given this change in exchange rate, the previously favourable position of imports has also been gradually weakened.

In particular, the reform of foreign exchange rate system in 1994 has had important effects on trade policy reform. The unification of the dual-tier exchange rates improved the

function of the foreign exchange rate as instrument for adjusting imports and exports. In combination with the elimination of the foreign exchange retention system, the immediate effects of exchange rate reform were that exports were stimulated by depreciation of domestic currency while imports were restricted. In early 1994, according to some analyses, the prices of imported commodities rose by 33.5% while the reduction of export cost was no more than 14.5% (the rate of depreciation from the real exchange rate of US\$1 = 7.6 *Yuan* at that time). Given that in China the price elasticity of demand for import commodities is usually larger than that of export commodities, the unification of the exchange rate in 1994 had greater effect in restricting imports than in promoting exports (Long Guoqiang 1994; Wang Zixian 1994). The growth rate of imports in 1994 was 11.2%, compared with that of 1993, and 20.7 percentage points lower than the growth rate of exports for that year.

Because of the high inflation rate, however, the stimulation from depreciation was basically exhausted by 1995 (Huang Xianhai 1996). The annual growth rate of exports was still high but dropped to 24.17%, 7.54 percentage points lower than that of 1994 (31.71%). In addition, as was mentioned previously, the marked growth of exports was attributed to additional factors, especially the reduction of the duty drawback rate. By contrast, the growth rate of imports increased to 15.29% in 1995. The gap between the growth rates of imports and exports was reduced. Starting from the end of 1994, the *Renminbi* has been on a trend of appreciation. Meanwhile, the inflation rate stood at 21.7% in 1994 and 14.8% in 1995. These factors seemed to be beneficial for the growth of imports. In 1996, although growth of foreign trade was slow due to the reduction of export incentives (duty drawbacks), the growth rate of imports (about 5.11%) was higher than that of exports (1.55%).

However, on balance, China's exchange rate policy had a relatively weaker influence on import control than other import policies. There were several reasons restricting the role of exchange rate in import adjustment. First, because of the extensive use of export incentives, the advantageous position of imports given by the overvaluation of the domestic currency was offset. The general trend of trade policies was to encourage the development of import-competing industries. Importing was only a channel for obtaining advanced foreign production facilities to support import-competing industries, rather than an available source

of profits. Second, in China's planned economy, the exchange rate was only an accounting tool so that it only had a small effect in adjusting imports. In building the market economy in China, the exchange rate has been assumed to be a policy instrument affecting trade flows. This was not, however, true until 1994 when the exchange rate mechanism was subjected to market forces based on the supply and demand of foreign exchange. This meant, in a situation without marketisation of the foreign exchange system, the exchange rate could not be an powerful instrument affecting trade flows. Third, as to be discussed in the following subsection, China had strict controls on domestic enterprises' access to foreign exchange. The consequence was that even importing could be profitable due to the over-valuation of the domestic currency, the restriction of exchange control in fact disabled the possible function of exchange rate in encouraging the increase of imports. Or, by way of contrast, administrative controls on access to foreign exchange, instead of the exchange rate itself, became the major means to restrict imports.

The reform of the foreign exchange system in 1994 restored the role of exchange rate in adjusting trade flows. The most important aspect of this reform for import liberalisation was that the exchange rate has been elevated to one of the main market instruments based on the market forces. The unification of the dual exchange rate contained a large devaluation of the *Renminbi*. Usually, a real devaluation can help reduce quantitative restrictions, given that the devaluation makes imports more expensive in domestic currency (Thomas and Nash *et al.* 1991, pp. 157-158). In this sense, an appreciation of the exchange rate replaces the role of quantitative measures to restrict imports. However, providing the previously unrealistic exchange rate and the removal of excessive export incentives, such a devaluation of the *Renminbi* was by no means a discrimination against imports.

### ***Access to Foreign Exchange***

Controlling foreign exchange use for imports was an important means of import restriction in China. As a developing country, China has been short of foreign exchange and exercised rigid controls over the earnings and use of foreign exchange by state-owned enterprises. Most imports were subject to, besides import quotas, exchange quotas controlled in accordance with state-approved import plans. With the reforms of trade and foreign exchange systems, especially while the foreign exchange retention system was implemented throughout the 1980s and the early 1990s, government controls over foreign exchange have been gradually released.

As early as 1980, in some localities, companies with excess retained foreign exchange were allowed to sell it to other firms who sought access to foreign exchange to purchase imports outside the plan. In 1986, some foreign exchange adjustment centres (FEACs) were established for the convenience of selling and buying foreign exchange. However, access to FEACs was subject to approval by MOFTEC and/or other authorities. This meant that domestic enterprises could not freely get foreign exchange from the FEACs. Even for an enterprise which had obtained foreign exchange by retention or by swap in the FEACs, the use of foreign exchange was still subject to government import controls. The function of FEACs in support of import expansion was to aid enterprises which already had import plans (quotas) but lacked foreign exchange to realise their imports.

Such a situation was changed in 1988, when the rights of retaining foreign exchange were expanded for enterprises and the foreign exchange market was further liberalised. The number of FEACs was increased and opened to state-owned and collectively owned domestic enterprises as well as foreign-funded enterprises. In addition, quota controls on using retained foreign exchange were phased out in the same year. Enterprises became able to import goods without quota or licence requirements by using their retained foreign exchange. The transactions volume of foreign exchange via FEACs increased rapidly from US\$6.3 billion in 1987 to US\$25 billion in 1992 (World Bank 1994a, p. 32).

By 1994, the previous FER system was abolished and the dual exchange rate system was unified. Enterprises no longer bear the mandatory plans to turn over their foreign exchange earnings to the central government. Under a newly established system of settlement and sales of foreign exchange, enterprises could sell their foreign exchange to designated foreign exchange banks. An enterprise in need of foreign exchange can, by presenting an import contract or other relevant certificates, purchase foreign exchange at authorised foreign exchange bank. The bank would in turn sell all foreign exchange above a specified quota (agreed reserve of foreign exchange to be retained in authorised foreign exchange bank for banking operations) to the central bank via the China Foreign Exchange Swap Centre, thereby forming an inter-bank foreign exchange transaction market. In the first year after the Centre began its operation (from 4 April 1994 to March 1995), the Centre's foreign exchange transaction volume reached US\$56.8 billion (Li Rongxia 1996).



With regard to foreign exchange usage, therefore, imports have now basically been freed of restrictions.

The latest reform measure was that, from 1 December 1996, China began, in accord with the obligation fixed in Clause 8 of International Monetary Fund (IMF) agreement, to establish the convertibility of *Renminbi* on current account. This meant that all restraints on foreign payments and transactions for foreign economic activities, such as commodity imports, payment for services, return of foreign debt interests and the outward remittance of foreign investor's profits, were removed (*People's Daily*, overseas edition, 29/11/1996, 3/12/1996).

Over the past twenty years, China's foreign exchange policy has fundamentally changed from the rigid restriction to the (partial) convertibility of domestic currency. Currency convertibility is essential to free trade between countries. The extent to which a currency can be converted into another reflects the degree to which an economy is integrated with the world. With a convertible currency, the linkage with the world markets provides the opportunities for the economy to make the maximum use of comparative advantage and improve the efficiency of resource allocation. Further, convertibility is a favourable condition in attracting FDI since it enables investors to avoid the risk of losses caused by the restraints of currency converting. In an economy like China where FDI has been important sources of development, demand for convertibility would naturally come from the foreign investors for repatriating their income in hard currency. Any control over foreign exchange in this sense would be obstacle to the inflows of foreign capital. Moreover, convertibility implies a stable financial environment to encourage trade expansion. Although international institutions like the IMF and GATT/WTO have no rule on full convertibility, the principles of free trade and national treatment have in fact included the requirement supporting the freedom for trade flows and capital movements.

It is worth noting that the realisation of the *Renminbi*'s convertibility was four years earlier than promised by China. This represented a reform of China's foreign exchange system supporting trade liberalisation. China previously scheduled making the *Renminbi* convertible at the end of this century. The convertibility of domestic currency has been an important step in liberalisation. Over the reform period, the inconvertibility of the *Renminbi* attracted criticism from domestic and foreign economists. Undoubtedly, China's financial

system reform will accelerate the process of import liberalisation although full convertibility of the *Renminbi* will still take time.

### **5.2.3 Other Import Control Measures**

#### ***Import Planning and Trading Rights***

Before reform, China's foreign trade system implemented a mandatory plan for over 3,000 commodities. It was only few national FTCs which had rights to trade with foreign countries. Thus, the mandatory planning of imports was at the heart of China's previous system for controlling imports and was a serious barrier to trading partners' access to China's markets. Therefore, trade plans have been the focus of concern for China's trading partners for a long time.

Following the decentralisation of trading rights, the scope of mandatory planning has been significantly reduced. Mandatory plans were replaced by a mixture of mandatory and guidance plans, and then market forces were introduced into the adjustment mechanism for imports. All importables were divided into three categories. Categories I and II, which were regarded as essential for national economic development and for people's livelihood, were subject to import planning and were dealt with by a limited number of designated FTCs at national and provincial levels, while Category III was freely handled by any FTC. By 1992, plan-controlled import commodities were reduced to 11, accounting for 9.1% of all HS lines and 18.5% of total imports. Prices of import commodities were determined by the market in 95% of cases and by the State in 5% (Fan Baoqing 1994; World Bank 1994a, p.63).

China's import plans were implemented with the assistance of canalisation of imports. It is worthy of note that although the scope of planning was reduced to a minimum level, the canalisation of imports was still playing important role in import controls. The World Bank's report (1994a) estimated there were about 32% of total imports under control through canalisation in 1992. Although the import plan system has been phased out in 1994, the trading enterprises were still under the supervision of their authorities, since these designated FTCs were state-owned enterprises which had tight administrative linkages with central or local governments. Enterprises had no rights to engage in importing trade following market signals and thus remained as government subordinates (Li Dongshen 1997). Governmental supervision has been functioning as import planning did before.

Furthermore, administrative means were sometimes used to directly control the type and volume of imports.

As a result of the gradual devolution in foreign trade, enterprises with trading rights have increased to 9,206 (excluding foreign-funded enterprises) in 1995. Compared with 12 before reform, the growth has been explosive. However, if the size of China's economy is considered, this number is still insufficient. In 1995, there were about 45 million industrial and trade enterprises in China. This meant less than 1% have been granted trading rights.

Some more comments on trading rights are needed. The right to trade is one of the basic rights of an enterprise in a market economy. Trading with other economic units, domestically or internationally, is an effective means to maximise the profits of the enterprise. Since China's reform effort was to develop market ingredients in the country (in the 1980s) and build a market economy (since the 1990s), the devolution of the previously centralised trading rights would have not been in question. However, because in China the transition of the economy was a gradual process, the granting of trading rights to localities and enterprises has been used as a policy for managing trade reform. Restraints on trading rights excluded the majority of the domestic enterprises from direct trade with foreign counterparts. Many opportunities selling products to and buying resources from the world markets have consequently been lost that might have enabled them to make efficient use of resources and improve productivity.

Of course not every enterprise needs to trade with foreign companies directly. However, for large and medium sized enterprises, the availability of trading rights seems more important. A survey carried out by The Institute of Market Investigation of Renmin University in 1994 showed that, of 1,071 enterprises from nine industries, about two thirds of enterprises had no direct trading rights while those with trading rights accounted for only 39.85%. Among the remaining 60.15% of enterprises, 28.03% claimed that the lack of trading rights was the biggest difficulty for the enterprise's exports (Huang Guoxiong 1994).

More importantly, the trading rights granting system has obstructed fair competition. Enterprises without trading rights were in fact discriminated against. They had to obtain factors and sell products domestically and accept domestic prices, regardless of how attractive the conditions in the world markets were. Alternatively, they could trade with

foreign counterparts indirectly via a trading agent by paying higher costs for covering the agent's profits. Enterprises with trading rights did not face such problems. The differential treatment for different enterprises discouraged competition in both industrial sectors and the foreign trade sector. The consequences were losses in allocative efficiency and industrial productivity.

In 1994, China committed itself to phasing out the trading rights granting system and adopting an auto-registration system in five years after its returning to GATT. In 1996, the WTO China Working Group approved a protocol on China's trading rights. The transitional period was agreed at three years after China's becoming the WTO member. This represents a positive step toward trade liberalisation.

### ***Technological Standards***

Another important aspect of import control arising in recent decades concerns technical standards, in both developed and developing countries. In some countries, the technical standards applied to imported products are extremely restrictive. Tong Jiadong (1994) cited from a report of the Trade Office of US Senate presented in 1993 that US has noted that China applied strict technical standards and requirements on imported products. For example, China requests a certificate showing the fertiliser content when agricultural products are imported. But the same rules are not applied to domestic products. Until 1997, the USTR has been criticising China for the maintenance of a statutory inspection requirement on imported goods. The major problems, cited by the USTR, "include the lack of transparency, difficulty in determining the appropriate standard, use of different standards on imports from different countries and different standards from domestic goods, and adoption of unique standards that differ from international standards for no identifiable reason" (USTR 1997).

Technological standards reflect the quality requirement of a country for ensuring the social security and economic order. It is not surprising that a country applies its prescribed inspection standards to import goods. In fact, most countries in the world have such a system. The real problem for China is that it should have a unitary, transparent technological standard system for both domestic and imported goods. It was also a precondition for providing foreign companies with national treatment which is considered as an important component of a neutral trade regime.

## 5.3 EVALUATING CHINA'S IMPORT LIBERALISATION

### 5.3.1 Effective Rate of Protection

A common method for evaluating the aggregate effects of import liberalisation is to measure the effective rate of protection (ERP) rather than looking only at nominal tariff rates. However, it is a very difficult task to measure and compare China's real degree of protection, due to the distortion of China's price system which has meant that internationally comparable data unavailable. Of the studies of China's foreign trade, only a few have touched on this aspect.

The World Bank (1994a) provided an estimate of the effective rate of protection to Chinese industry based on 1991 data. Of the 16 industries covered in the World Bank's estimate, the chemicals industry had very high effective rate of protection and 10 industries appeared to have negative value added at international prices. This suggests, 11 of the 16 industries were highly protected while protection in other 5 industries were negative, although accurate measures of the degree of protection are not available in this estimation.<sup>[2]</sup>

Another estimate provides more detailed information for understanding the real degree of protection in China. Zhang Shuguang *et al.* (1997) in their research project, sponsored by the US Institute for International Economics, measured the effective rate of protection in 25 commodities based on carefully adjusted 1994 data.<sup>[3]</sup> The results of their estimate show that the effective rates of protection (tariff rate plus tariff equivalent of NTBs) in the 25 commodities were varied, with the highest of 141.40% (sugar) and the lowest of 13.02% (micro-computer). The trade-weighted average rate of effective protection in 1994 was 43.29%, consisting of 21.74% of adjusted tariff rate and 21.55% of tariff equivalent of NTBs. The ratio of imports to total supply (domestic products plus imported products) reached 35.96%, while the calculated value of total supply is above 1,500 billion *Yuan*.

Unfortunately, it is not possible to compare the 1994 effective rate of protection in China with that of 1991, since the World Bank's estimate lacks an estimate of average levels covering all measured industries. However, Zhang Shuguang *et al.* in their study compared China's degree of protection with those of Japan and United States. A very

important conclusion is that China's effective rate of protection (43.29%) in 1994 was higher than that of the USA (35.2%, based on 21 products covering a total value of US\$260 billion) in 1990 but lower than Japan's (178.2%, based on 5 large categories of products covering a total value of about US\$442 billion) in 1989 (Zhang Shuguang *et al.* 1997). If this conclusion is correct, it is safe to say China's market is more open than Japan's. In addition, China's import ratio (35.96% in 1994) was higher than those of the United States (21.21% in 1990) and Japan (11.7% in 1989), suggesting a considerably large proportion of China's market open to foreign countries. This means, at least in the range concerned, China is highly dependent on world market supply. Opening up China's market to the outside world is an important condition for China's economic development.

### **5.3.2 Remaining Problems of China's Import Liberalisation**

China's recent intensive effort in reducing import barriers has certainly been impressive. With regard to trade liberalisation, however, there are still some problems in China's import policy. Of these the main ones are:

First, that import policy reform has lagged behind other trade policy reforms. In the first decade of reform, China's emphasis was put on institutional adjustment (decentralisation) and the formation of export incentives (foreign exchange retention system and duty drawback system). Changes on import policies were either strictly limited to devolving the rights of import controls or simply to increasing restraints to imports. A typical example is the import licensing system. Since it was introduced in 1980, the number of imports subject to licences increased from 13 in 1980 to 53 in 1988 and the following several years. Devolving the rights of licence issuing had never meant relaxation of import controls. The real reduction of quantitative control over imports began in 1993/4 and continued in 1996. The tariff reductions began a little earlier than licensing system reform but had less significance on real import liberalisation because the effects of import tariffs were offset by numerous preferential tariff exemptions operative before 1996.

Second, adjustments in tariff policy have led to the restoration of a high tariff system in terms of real tariff rate, given that China's real tariffs were extremely low due to the use of tariff exemptions. Tariff exemption policies adopted prior to 1996 made China's real average tariff level much lower than the average nominal tariff rate. This means, theoretically, that China had the capacity for committing itself to larger tariff reductions. In

fact, reducing the nominal tariff rate and bringing it closer to the level of the real tariff rate will not harm China's tariff revenue, trade balance and import structure. Generally, tariff reduction may lead to an increase of imports. However, in China's case, due to the implementation of preferential tariff policies, tariffs have been divided between nominal rates and real rates. Tariff reduction only refers to a decrease of nominal tariff rates. That is to say that the increase in concessional imports might be irrelevant to the reductions of nominal tariffs if the tariff concession structure remains unchanged. Only those imports which do not enjoy tariff exemptions would be stimulated by a tariff reduction. However, this group of imports was small and accounted for only about 15% of total imports in 1995 (*Economic Daily* 12/2/1996). In addition, of course, there would be a requirement to adjust the existing tariff structure. If the requirement of structural adjustment is taken into account, there would be the possibility of reducing the average tariff rate closer to the level of the real tariff.

The readjustment of tariff policies in 1996 seemed to restore the role of tariffs in import controls. If the 1996 policies are fully implemented, the distance between the average level of the real import tariff and the nominal tariff rate will be largely reduced. This implies an increase of barriers to imports, compared to the rates of actual collected tariffs.

Third, quantitative measures still cover a large number of imports. It was estimated that in 1992 NTBs (excluding foreign exchange controls) covered about 51.4% of total imports in China. Among these, 25.1% of total imports were subject to import licences (World Bank 1994a, pp. 63, 65). Although two major reductions were undertaken in 1994 and 1996, there are at least 200 varieties of commodities still subject to import licensing. In addition, import quotas have never been published since it was regarded as commercially confidential. China's promise is that she will publish all import quotas once she is allowed to enter the WTO (Wu Jiahuang 1996).

Finally, trading rights continue to be a policy instrument used to control trade flows. China insists on controlling imports by limiting the number of enterprises with access to foreign trade. There are two kinds of limitation. One is the canalisation system of trade in which certain number of import commodities, 12 in 1995 and 14 in 1997, are handled only by designated FTCs (Li Dongshen 1997). The other concerns whether or not an enterprise is allowed to operate foreign trade. At present, most industrial and commercial enterprises

have no rights to engage in trade with foreign companies. The founding principle of the import and export agent system which was introduced in 1984 has not been enterprises' requirement of balancing profits and costs, but the lack of direct trading rights. The award of trading rights has been used as a preferential treatment to favour certain enterprises. This process produced some negative results. First and foremost, the very fact that an enterprise's trading rights are subject to administrative examination and approval, reflects the fact that government intervention over foreign trade still obstructs trade liberalisation. Another problem is that designated FTCs and other enterprises have in fact obtained a competitively advantageous position. Fair competition cannot be fully developed between enterprises with and those without trading rights. This situation undoubtedly contradicts principles of the market economy. Furthermore, the system of trading rights distribution, subject to administrative examination and approval, has reduced potential opportunities to conduct trade with foreign counterparts since many enterprises are not permitted to engage in international trade. Foreign companies regard the present trading rights system as one of the most significant obstacles to doing business in China and trading with Chinese enterprises (USITC 1997; USTR 1997). China has promised that it would grant trading rights to foreign and domestic firms in China (USITC 1997). Some Chinese economists have also called for the replacement of the trading rights granting system by a registration system (for example, see Wang Zixian 1997a). It is reported that such a registration system will be in effect before the year 2000 (Liu Xiangdong 1997). It seems the phasing-out of the trading rights granting system is one of the most important steps to liberalising China's trade regime and trade policies.

In sum, China's import policy reforms fall into two categories: One is the elimination or reduction of import barriers; the other is the establishment or normalisation of the import adjustment mechanism. Since 1991, China has taken a series of measures to adjust its import policies. Import barriers, especially tariffs, have been much reduced. In the mean time, with the development of domestic market systems, China has taken actions to establish a macroeconomic control system on the basis of market mechanisms.

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[1] The trade forms of "inward processing with supplied materials" (*Lai Liao Jia Gong*), "inward assembling with supplied parts" (*Lai Jian Zhuang Pei*), "processing according to buyer's samples" (*Lai Yang Jia Gong*) and "compensation trade" (*Bu Chang Mao Yi*) are briefly named *San Lai Yi Bu* -- three "Lai"s and one "Bu" in Chinese.



<sup>[2]</sup> ERP is simply defined as follows:

$$ERP_j = (VAD_j - VAW_j) / VAW_j$$

where VAD equals value added in  $j$  at domestic prices; VAW equals value added in  $j$  at world prices. For more details about the ERP method, see Krueger (1984), Greenaway (1988), and Naqvi and Kemal (1991, Chapter 2).

According to the ERP methodology, when value added at world prices is zero or negative, it implies an extremely high rate of protection. Therefore, the World Bank has an assessment in China's case that the industries with negative value added at world prices would not appear to be able to survive under full trade liberalisation (World Bank 1994a, p. 75).

<sup>[3]</sup> Data adjustments involved factors including domestic price policies, import value-added taxes and consumption taxes, preferential tariff rates and tariff exemptions, exchange rates, value of processing trade, etc. to exclude the abnormal influences caused by these factors. For details, see Zhang Shuguang *et al.* (1997).

## **6 Trade Policy Reform and Economic Development**

Comparing China's present trade system with that of some two decades ago, trade policy reform has certainly been fruitful. These reforms have effectively made China's economy much more open and improved the nation's capacity to participate in the world economy. The opening of the economy has in turn promoted economic growth. In this chapter, I intend to use some econometric methods, in addition to the preceding analyses provided, to evaluate the aggregate effects of trade policy reform in China.

### **6.1 GENERAL EFFECTS OF TRADE POLICY REFORM**

The effects of trade policy reform have been multi-faceted. At the forefront, China's foreign trade has grown rapidly. Meanwhile, trade structure and competitiveness have been much improved. With the fast growth of foreign trade and sustained trade policy reform, the degree of openness of the economy has also been much enhanced.

#### **6.1.1 Trade Expansion and Openness of the Economy**

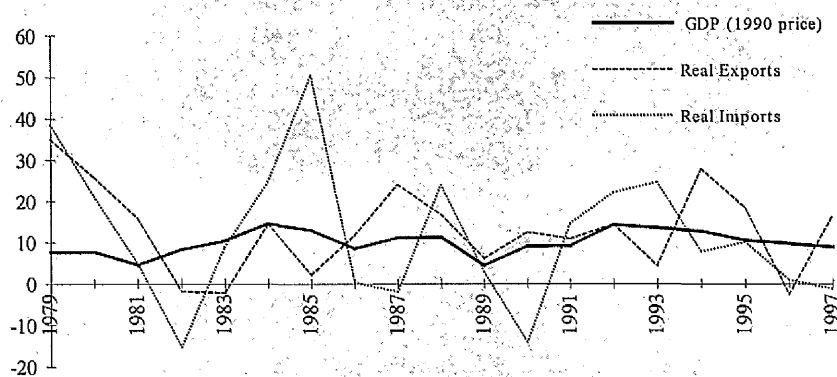
Statistics presented in Chapter 1 (Table 1.1) shows that China's trade has grown rapidly in the reform period. In relative terms, the openness of the economy also increased. In fact, there exists a mutually reinforcing between trade growth and the economic openness.

In order to carry on the discussion, two features of China's trade growth are worth noting. First, China's foreign trade has been following on a favourable trend of development since the beginning of trade reform. Both exports and imports have expanded at a rapid pace. The average annual growth rates of exports and imports during this period were in the top range in the world. The basic reason behind the rapid growth has been the dramatic opening of the country to foreign trade and investment. The opening-up of the economy has led to positive policies encouraging the development of foreign trade in keeping up with the tide of increasing international interdependence.

Second, the growth rate of foreign trade has fluctuated over time. Figure 6.1 compares the growth rates of GDP, exports and imports. To exclude the effects of inflation, values of

GDP in constant 1990 prices are used. Correspondingly, real exports and imports are obtained by adjusting the published figures in US dollars with the US CPI (1990=100). As can be seen, while the annual growth rate of GDP during 1979-1997 changed between 5% and 15%, the real export growth fluctuated in a larger range from minus 2% to 34% and that of real imports fell in the range between minus 15% and 50%. The growth of GDP was relatively more stable than that of exports and imports. This in fact implies that the growth of exports and imports were affected, in addition to the overall changes of the nation's general economic policies, by the changes in policies specific to trade.

**Figure 6.1 Growth Rates of GDP, Exports and Imports**



Source: State Statistical Bureau (1996b, 1997b); *Wen Wei Po* 12/1/1998; *China's Scholars Abroad*, 9/1/1998.

Although with obvious fluctuation in growth rates, the quick expansion of foreign trade indicated that China has been rapidly connecting itself with the world economy. Before reform, most products produced by Chinese enterprises were sold domestically, since exports accounted for a small proportion of GDP (or GNP). The opening-up of the economy changed such a situation. According to a survey of 1,071 industrial enterprises in 1994, the proportion of enterprises whose products were sold entirely in the domestic market was only 23.28% (Huang Guoxiong 1994). This suggested more than three-quarters of enterprises have links to the external markets directly or indirectly. At the nation-wide level, the ratio of foreign trade to GDP increased from 9.79% in 1978 to 46.12% in 1994 (36% in 1997). The ratio of exports to GDP has reached about 20% in recent years. On the other hand, trade liberalisation also led to a rapid increase of imports, both for production expansion and to supplement domestic markets. The share of imports to GDP rose from 5.2% in 1978 to 22.54% in 1994 and dropped to 15.76% in 1997.

Table 6.1 *China's Ratio of Foreign Trade to GDP*

(%)

	1978	1980	1985	1990	1991	1992	1993	1994	1995	1996	1997
Ratio of exports to GDP	4.62	6.06	9.49	16.59	18.58	18.49	16.70	23.58	21.37	18.73	20.23
Ratio of imports to GDP	5.17	6.68	14.77	14.21	16.50	17.53	18.93	22.54	18.96	16.77	15.76
Ratio of foreign trade to GDP	9.79	12.75	24.25	30.78	35.07	36.01	35.63	46.12	40.33	35.50	36.00

Source: State Statistical Bureau (1996b, 1997b); *Wen Wei Po* 12/1/1998; *China's Scholars Abroad*, 9/1/1998.

These ratios gave an impression that China's economy has been closely integrated with the world markets. In some ways, this is correct, since a large portion of economic activities was linked to foreign trade and all data in the table are statistically correct according to China's current statistical standards. On the other hand, however, there are some problems in using these ratios to estimate China's real degree of openness. These problems involve the overestimation of foreign trade and underestimation of GDP (or GNP), due to the inappropriate range of statistical indicators, unrealistic exchange rates and the special pattern of China's foreign trade (*China Economic Times*, 11/8/1995; Zhu Linan 1995).

Measuring China's GDP (or GNP) in terms of US dollars has become an important issue in evaluating Chinese economy, particularly since 1993 when the International Monetary Fund (IMF) presented a new estimate of China's GNP (*World Economic Outlook* 1993). For a long time, the World Bank has been using an *Atlas* method<sup>[1]</sup> to estimate GNP per capita for economies which were covered by the *World Development Report*, dividing them into three groups: low-income, middle-income and high-income economies. By the *Atlas* method, China's 1990 GNP per capita was US\$370.

However, some economists, and the World Bank itself as well, have realised that the *Atlas* method associated with exchange-rate conversion estimate has some shortcomings which limit comparability between countries.<sup>[2]</sup> To improve the comparability of the data across countries, some economists have used the purchasing-power-parity (PPP) method to estimate the real level of China's GDP. The World Bank also began to provide an alternative estimate by using the PPP method. Lardy (1994) analysed some estimates and came to the conclusion that "China's real per capita income in 1990 is about three times the exchange rate-based estimate — something around US\$1,100 per capita". That is to say that "China's 1990 GNP would be \$1.25 trillion" (Lardy 1994, p. 18). In *World Development Report 1996*, the PPP estimate of China's 1990 GNP per capita was US\$1,000 (World Bank

1996, p. 2), close to Lardy's estimate. The reason for previous underestimation of China's GNP (or GDP), as Lardy points out, is that "the Chinese currency depreciated significantly during the 1980s. In 1980 the exchange rate averaged 1.5 *Yuan* per dollar; by 1990 the average rate was 4.8 *Yuan*. The depreciation cut the World Bank's estimate of per capita GNP by two-thirds" (Lardy 1994, p.14).

Chapter 4 analysed that processing trade accounts for a large proportion of China's total trade. Because of the special requirement of inward processing, the relevant imports and exports (processing trade) cannot be regarded as an indicator of the openness of the economy. Therefore, to measure the real degree of China's openness in trade, it is necessary to apply an appropriate adjustment to related indicators. Zhu Linan (1995) developed an approach, including borrowing the PPP method<sup>[3]</sup> to estimate China's GDP or GNP, excluding the value of service trade and using net export value of processing and compensation trade, to correct for factors causing overestimation or underestimation.

Regarding this approach, it is understandable that processing trade should receive special attention. But, only taking net exports of processing trade into account may also lead to underestimate of foreign trade. Apart from net exports which reflects the value-added in the processing industries, what should also be included are imports of machinery and equipment, which indicate the increase of production capacity in processing industries. Although a complete set of data for all years is difficult to obtain, it can be roughly estimated by applying a nation-wide ratio of equipment imports to total imports (in 1996, this ratio was 17.9%), assuming processing industries had the same ratio of equipment imports. By such adjustments, the value of raw materials and intermediate products flows for processing trade could be excluded from total trade and the remaining figures could be considered as general trade. Further, adopting PPP estimates of GNP also could be a means of correcting the underestimation of GNP caused by the unrealistic exchange rates. However, in order to conform with international common practice, it is not necessary to exclude the tertiary industry from GNP. China's real degree of openness to trade during 1991-1995 is recalculated as in Table 6.2.

**Table 6.2 The Real Degree of China's Openness in Trade**

(US\$ billion; %)

	PPP estimates of GNP <sup>a</sup>	National exports & imports	Ratio of foreign trade to GNP (PPP)	Processing trade (exports & imports)	Equipment imports in processing trade	Net exports of processing trade	Real degree of openness in trade <sup>c</sup>
1991	1,660	135.63	8.17	51.49	9.22	7.44	6.07
1992	2,220	165.53	7.46	71.12	12.73	7.09	5.10
1993	2,504 <sup>b</sup>	195.70	7.82	80.60	14.43	8.28	5.50
1994	2,986	236.62	7.92	104.54	18.71	8.31	5.33
1995	3,505	280.85	8.01	132.07	23.64	15.31	5.36

Note: *a*: Based on World Bank data.*b*: Estimated by the author, based on the average of implied PPP exchange rates in 1992 (US\$1 = RMB1.20) and 1994 (US\$1 = RMB1.56).*c*: Degree of openness = {(national exports & imports - processing exports & imports + equipment imports in processing trade + net exports of processing trade) / PPP estimates of GNP} \* 100%.Source: World Bank (1994b, 1996, 1997); State Statistical Bureau (1996b); Yang Shengming *et al.* (1996).

The ratio of foreign trade to GNP(PPP) around 8% in 1991-1995 seems a reasonable indicator of China's integration into the world economy, compared to the nominal degree of openness (ratio of foreign trade to GDP or GNP). If, as some authors suggested, China's GDP would have to be raised two or three times to bring the export (foreign trade) ratio within the normal range (Garnaut and Huang 1995, p. 15), most of the ratios shown in Table 6.1 would be much lower. For example, if GDP in 1978 was doubled, the ratio of foreign trade to GDP in the year would be lower than 5%. Considering the ratio in the 1990s were around 8%, the implicit conclusion is that China has increased its dependence on international markets. However, the differences between the ratio of foreign trade to GNP(PPP) and the real degree of openness suggest that there were about a quarter to one-third of the ratio of foreign trade to GNP(PPP), instead of the near half in the nominal ratio (Table 6.1), should be attributed to the development of processing trade.

### 6.1.2 The Improvement of Competitiveness

China's openness toward the outside world increased the importance of the world market to the economy. The reduction of trade barriers meant the opportunities for foreign companies to access to China's markets and for Chinese products to enter the world market. This situation, on the other hand, also meant that most Chinese enterprises and trading companies have had to face intensive competition in both domestic and overseas markets. The introduction of foreign competition helped in improving the efficiency of Chinese enterprises and trading companies. The competitiveness of Chinese export commodities, from an aggregate viewpoint, has been enhanced through the reform period. But the changes varied from sector to sector, and from product to product.

### *The Change of Export Structure*

Before reform, China's exports were dominated by primary products. This situation was changed after the end of 1970s, with the impact of reform and openness. Although China's trade policies have not yet allowed the enhancement of export structure to be the first priority, trade policy reform or liberalisation has in fact promoted the improvement of export composition.

The share of manufactured exports has exceeded that of primary exports since 1981, although labour-intensive manufactured exports accounted for a large part of it. With the rapid growth of industrial production and the increasing importance of technological progress for economic growth, the proportion of manufactured exports in total exports also increased. Of the total exports, the exports of manufactures (SITC 5-8 less 68) increased from 47.5% in 1980 to 85.6% in 1996, while primary exports (SITC 0-4 plus 68) dropped from 51.3% to 14.4% in the same period.

With regard to manufactured exports, the tendency has been to develop high value-added manufactures instead of labour-intensive products. For example, exports of mechanical and electrical products, which have a relatively higher ability to increase foreign exchange earning and have a bigger impetus spurring on the development of industry, have grown rapidly since reform (Table 6.3).

**Table 6.3 Exports of Textile, Mechanical and Electrical Products** (US\$ billion)

	1978	1980	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
<b>Textiles &amp; textile articles*</b>	n.a.	3.80	5.08	6.90	9.20	10.88	12.63	13.30	16.23	24.62	26.06	35.55	37.97	37.03
<b>Mechanical &amp; electrical</b>	0.65	1.41	1.67	2.48	3.80	6.16	8.32	11.09	14.12	19.55	22.70	32.00	43.86	48.21

\*: Figures prior to 1992 include exports of textile yarn, fabrics, made-up articles of textile materials, and articles of apparel and clothing accessories. Figures since 1992 refer to HS section XI (Textiles and textile articles).

Source: State Statistical Bureau (1992, 1995); State Planning Committee (1997).

The exports of textile products during 1980-1996 increased about 8.74 times, at an average annual growth rate of 15.29%. By comparison, the value of mechanical and electrical exports in 1996 was 34.19 times of that in 1980, growing at an average annual growth rate of 24.70%. China adopted a number of policy measures to promote manufactured exports. The growth of manufactured exports was the result of these preferential trade policies toward manufacturing sectors. In 1995, exports of mechanical and electrical products for the first time exceeded textile exports and became China's

largest category of exports. The ratio of machinery and electrical exports in total manufactured exports increased from 12.4% in 1985 to 37.33% in 1996.

The change in export structure, as a result of improvement of the domestic economic structure, reflected the positive effect of China's industrialisation effort. On the other hand, the increase in manufactured exports also showed that the external competitive ability of Chinese manufactured export has been greatly strengthened. This suggested that the China's pattern of participating in the international economy has been changing, from a supplier of primary goods to a competitive supplier of manufactured exports in the world markets. However, in order to see to what extent China has changed its export structure, we now need to identify the sources of changes in export structure and the improvement in competitiveness.

### ***China's Comparative Advantage***

For the purpose of measuring a country's comparative advantage and trade performance, a commonly adopted approach is to construct an index of revealed comparative advantage (RCA) which was firstly developed by Balassa (1965) in the 1960s. RCA is defined as the share of country  $i$ 's exports in world trade of product  $j$  divided by that country's share of world trade, as showing in the following equation:

$$RAC_{ij} = (X_{ij} / X_j) / (X_{iv} / X_{nv}) \quad (6-1)$$

where  $X_{ij}$  is the exports of commodity  $j$  by country  $i$ ;  $X_j$  is world total exports of commodity  $j$ ;  $X_{iv}$  is total exports of country  $i$ ;  $X_{nv}$  is world total exports. If country  $i$ 's share of world exports of commodity  $j$  ( $X_{ij} / X_j$ ) is greater than country's share of world total exports, then  $RCA_{ij} > 1$  and a comparative advantage is revealed (Ballance 1988; Greenaway and Milner 1993).

In addition to the above equation, a net export index can also be calculated to show a country's trade performance. This index is to measure the net exports as a percentage of total trade. The equation is:

$$NX_{ij} = (X_{ij} - M_{ij}) / (X_{ij} + M_{ij}) \quad (-1 \leq NX_{ij} \leq 1) \quad (6-2)$$

where  $NX_{ij}$  refer to net exports index of country  $i$  in commodity  $j$ ,  $X_{ij}$  and  $M_{ij}$  are country  $i$ 's export and import values of commodity  $j$  respectively. The range of the NX index will be



valid between -1 and 1. The closer to 1 the NX index is, the greater comparative advantage the commodity has.

Yeats (1991) computed China's RCA indices in the period of 1965-1987 and concluded that China has a revealed comparative advantage in a relatively broad range of labour-intensive products. Cheng Huifang (1995) also calculated China's aggregate RCA indices during 1953-1990 which shows China's primary exports had revealed comparative advantage until the late 1980s, while manufactured exports have developed revealed comparative advantage (RCA index exceeded unity) thereafter.<sup>[4]</sup> Note that there was a turning point of China's revealed comparative advantage in the late 1980s, as suggested by Cheng Huifang's result. Yeats' study only covered the period prior to the turning point. Therefore, it is necessary to see whether China's revealed comparative advantage has changed since the 1990s. I computed China's RCA indices for the period of 1990-1995. The results at aggregate levels are listed in Table 6.4 (More detailed results at two- and three-digit levels can be seen in Appendix Table at the end of this thesis).

**Table 6.4 Indices of China's RCA and Trade Performance (1990, 1995)**

SITC	Description	China's Exports		China's Imports		World Exports		RCA		NX Index	
		1990	1995	1990	1995	1990	1995	1990	1995	1990	1995
0-4 (+68)	Primary exports	16.483	23.417	10.432	24.737	913.287	1114.216	0.99	0.70	0.22	-0.03
5-8 (-68)	Manufactured exports	33.983	126.156	33.923	106.648	2422.023	3737.989	0.77	1.12	0.001	0.08
0 and 1	Food, beverages & tobacco	6.951	11.323	3.492	6.525	296.463	408.916	1.29	0.92	0.33	0.27
2	Crude materials, inedible, except fuels	3.537	4.375	4.107	10.158	164.396	215.418	1.19	0.68	-0.07	-0.40
3	Lubricants & related materials	5.237	5.335	1.272	5.127	363.995	359.537	0.79	0.49	0.61	0.02
4	Animal & vegetable oils, fats & waxes	0.161	0.454	0.982	2.601	13.336	25.712	0.67	0.59	-0.72	-0.70
5	Chemicals and related products	3.73	9.904	6.648	17.3	303.531	473.406	0.68	0.70	-0.28	-0.27
7	Machinery & transport equipment	5.588	31.391	16.845	52.638	1208.731	1925.093	0.25	0.54	-0.50	-0.25
6 and 8	Other manufactured articles	25.262	86.791	11.009	37.036	984.858	1444.123	1.41	2.00	0.39	0.40

Note: Values of world exports and China's exports and imports are in US\$ millions.

Source: State Statistical Bureau (1996a, 1996b, 1997a, 1997b); MOFTEC (1997); State Planning Committee (1997); United Nations (1993, 1996, 1997)

Several points are worth noting from the changes of China's RCA indices in the 1990s. First, at the aggregate level, the results confirmed the tendency suggested by Cheng Huifang's calculation of RCA indices for primary exports to have been declining since the 1980s and turning to a comparative disadvantage in the 1990s, while a revealed comparative advantage has been developed in manufactured exports. By 1995, revealed comparative advantage remained in only a few primary products, such as silk (SITC 261,

RCA 33.65), crude fertiliser and minerals (27, 2.30; crude fertilisers, 271, 1.09), live animals for food (001, 1.59), non-alcoholic beverages (111, 1.75) and tobacco (121-122, 1.42). Instead, the RCA index of manufactured products increased from 0.77 in 1990 to 1.22 in 1995, The enhancement of RCA in manufactures reflects China's industrialisation efforts since reform.

Second, Yeats' conclusion that China's revealed comparative advantage lies in labour-intensive manufactures has remained the case in the 1990s. Typical examples of labour-intensive manufactures with RCA index larger than unity in 1995 include textile articles (SITC 658, RCA 6.73), travel goods (831, 6.59), cotton fabrics (652, 5.48), toys and sport goods (894, 5.24), clothing and accessories (84, 4.93), wood manufactures (635, 2.12), textile yarn (651, 2.14), plastic articles (893, 1.77), furniture and relative parts (821, 1.31). Relative trade performance indices (NX indices) were also favourable for most of these products. Such a structure of China's RCA is consistent with its abundant labour force and low level industrialisation.

Third, however, there was a favourable tendency in the changes of China's RCA: RCA indices of some relatively higher value-added products have rapidly increased in the 1990s. For example, the RCA index of office machines (SITC 751) increased from 0.76 in 1990 to 1.82 while optical instruments (SITC 871) increased from 0.36 to 1.36, emerging as a comparative advantage product. For some other products, whilst not yet proving internationally competitive, have had their revealed comparative disadvantage significantly reduced in the same period. Examples involve automatic data processing equipment (SITC 752, from 0.08 to 0.62) and medical instrument (SITC 872, from 0.16 to 0.34). If this trend can be sustained and extended to other relatively higher value-added and high-tech products, China's export structure will be certainly improved.

From the above RCA analysis, the conclusion that China has successfully improved its export structure and its international competitiveness could be reached. This conclusion may also be proven by checking up the share of China's exports in foreign markets. For example, in the United States and Japan, both are China's major export markets, the shares of many China's export products have expanded. Lloyd and Toguchi (1996), by performing a constant market share (CMS) analysis, shows that the shares of imports of these two countries from China for almost all manufactures (two-digit manufacturing industries)

significantly increased in the period of 1980-1993 and the improvement of competitiveness became the dominant factor for the market share expansion. By using newer data, it was also shown to be the case that China's exports to these two markets grew fast. In 1990-1996, China's share in United States total imports increased from 3.1% to 6.65% while the share of imported manufactures from China increased from 3.9% of US total imports of manufactures to 7.32%. In the same period, China's share in Japanese total imports expanded from 5.1% to 11.58% while the share of imported manufactures from China increased from 5.7% of Japanese total imports of manufactures to 14.0% (WTO 1995, 1997). Interestingly, prior to China, no other country has captured a proportion of more than 10% of Japan's manufactured imports except the United States. Undeniably, the improvement of competitiveness has been the most important factor promoting China's growth of exports. The increase of China's exports to the markets of industrial countries suggests that, by and large, China's manufactured exports have been internationally competitive.

## **6.2 TRADE POLICY REFORM AND TRADE PERFORMANCE**

The goal of trade policy reform is of course, based on the assumption that trade could contribute to (or lead to) economic growth, to improve a country's trade performance in order to promote economic growth. For a reforming country, however, it is logically necessary to examine the effects of trade policy reform before testing the relations between trade and economic growth. In this section, therefore, the task is to discuss the relations between trade policy changes and trade performance, referring to the case of China.

### **6.2.1 The Methodology and Data**

#### ***Cointegration Analysis***

The Engle-Granger cointegration analysis method is adopted here. The principle of cointegration analysis is that two (or more) non-stationary time series are cointegrated if there is a linear combination of them that is stationary (Engle and Granger 1987). This is to say, there exists a long-run relationship between the two time series. Cointegration analysis consists of the following two steps:

(1) *Unit root test*. A time series is said to be integrated of order one (i.e.,  $I(1)$ ) if its first difference becomes stationary. This time series has a unit root. All time series to be tested for cointegration need to be  $I(1)$ . To check for the existence of a unit root, we usually employ the Augmented Dickey-Fuller (ADF) test in the form

$$\Delta y_t = \alpha_0 + \alpha_1 t + \alpha_2 y_{t-1} + \sum_{i=1}^k \alpha_{3i} \Delta y_{t-i} + u_t \quad (6-3)$$

where  $\Delta y_t = y_t - y_{t-1}$  is the first difference of time series  $Y_t$  which is to be tested for unit root;  $t$  is the time trend;  $u_t$  is the error term and  $k$  is number of lag term(s) used. Hypothesis test will be carried out as  $H_0: \alpha_2 = 0$  against  $H_1: \alpha_2 < 0$ . A negative, significant  $t$ -value for  $\alpha_2$  will reject the hypothesis of unit root (i.e.,  $H_0: \alpha_2 = 0$ ) in the series  $Y_t$  and imply that  $Y_t$  is stationary rather than integrated.

(2) Cointegration test. If two time series are integrated of the same order,<sup>[5]</sup> the cointegrating regression can be run to seek the relation between them. For example, whether there is a cointegrating relationship between exports and exchange rate can be estimated by regressing exports on exchange rate. In a logarithmic form, the equation is

$$LX_t = \beta_0 + \beta_1 LEERX_t + v_t \quad (6-4)$$

where  $LX_t$  and  $LEERX_t$  denote the natural logarithms of exports and effective exchange rate respectively, while  $v_t$  refers to error term.

Based on the regression results, if the cointegration relationship exists between the two time series, an error correction model (ECM) is called for to test their long-run casual relationship. The general form of the ECM for the above regression can be expressed as:

$$\Delta LX_t = \theta_0 + \theta_1 ecm_{t-1} + \sum_{i=1}^n \theta_{2i} \Delta LX_{t-i} + \sum_{j=1}^m \theta_{3j} \Delta LEERX_{t-j} + \varepsilon_t \quad (6-5)$$

where  $ecm_{t-1}$  is the lagged residuals (i.e., error-correction term  $v_t$ ) obtained from the cointegrating regression;  $\varepsilon_t$  is the new error term while  $n$  and  $m$  are the numbers of lags used. It is said that there should be a causal relationship between two variables if they are cointegrated. The ECM provides additional long-run information, through the error correction term, for identifying this Granger causality. In this ECM regression, a statistically significant  $\theta_1$  (that is,  $\theta_1$  is obviously unequal to zero) suggests that exchange rate Granger cause exports. This is to say that exchange rate as a trade-related policy has effects on export growth.

Econometric computations for the cointegration analysis in this thesis were carried out by using an econometric software *Microfit 4.0* (M. Pesaran and B. Pesaran 1997, OUP).

### *Implications and Data*

Trade performance (growth of exports and imports) could be affected by a wide range of trade and trade-related policies. In the case of China, as discussed in Chapters 4 and 5, these policies involved subsidies, exchange retention, duty drawback, pricing, tariffs, quotas and licensing, exchange rates, and so on. All these policies were likely to have their influence on trade growth. However, given the fact that there is a lack of sufficient published information, especially data on trade restrictions, it is difficult for researchers to investigate the relationships between trade policy reform and trade growth in China.

Fortunately, the above described cointegration analysis has provided an approach to examine the effects of trade or trade-related policies on trade growth. But there are two things which need to be determined before applying the cointegration analysis to the case of China. First, what kind of cointegration test can be done? A fact of China's trade policy reform is that many policy measures were temporary, with frequent launching and phasing-out. More importantly, data related to these policies have rarely been published. It is impossible to construct a complete data set covering all these aspects. Although techniques for multivariate cointegration analysis are now available, the lack of data led to the decision that only bivariate cointegration analysis be undertaken in this study.

Second, what will be the basic variables to use in the cointegration test? The strategy for performing integration analysis here is to establish a bivariate model as a basic model and treat other policies as dummy variables for the specific years, when they took effect, so as to evaluate their influences. Obviously, while export growth is certainly the dependent variable, the most suitable independent variable is the exchange rate because of the availability of information and its special position in China's trade policy system.

Although China's original decision for economic opening was made in 1978, trade and related policy changes actually took effect after 1979. Consequently, exports began a new period of high growth and the exchange rate experienced a turning point going from appreciation to devaluation. Although the study focused on the post-1978 period, data used in the present cointegration analysis has been extended by three years prior to 1979, in order to include the 1979 turning point as a policy change in a continuous process of development. That is, data used for modelling covers the period between 1976 and 1997.

Export and import data are from China's official statistics as in Table 1.1 of Chapter 1. Exchange rate data are somewhat complicated. A handy set of data is the nominal exchange rates available from official statistical source. However, in a multiple exchange rate system, which was the case for China between 1980 and 1993, the nominal exchange rates were not always effective for foreign trade activities. Apart from the nominal exchange rate, some other forms of exchange rate existed, including "internal settlement exchange rate" and "swap exchange rate" or "adjustment exchange rate". The co-existence of dual (or multiple) exchange rates, together with other trade policies, resulted in different effective exchange rates for exporters ( $EER_x$ ) and importers ( $EER_m$ ).

To examine the effects of exchange rate on exports, and/or imports, the real effective exchange rate (REER) is usually preferred by researchers because it reflects the actual devaluation or appreciation of the exchange rate. The standard method for computing REER is given by

$$REER = RER * (1 + t_{Mi} - t_{Ei} + n + p + s + r) = EER * (P^s / P^d) \quad (6-6)$$

while the real exchange rate (RER) and EERs can be constructed as:

$$RER = e_{nom} * (P^s / P^d) \quad (6-7)$$

$$EER_x = e_x * (1 - t_{Ei} + s + r) \quad (6-8)$$

$$EER_m = e_m * (1 + t_{Mi} + n + p) \quad (6-9)$$

where  $e_{nom}$  is official (nominal) exchange rate (OER) in effect or applied exchange rate (AER);  $e_x$  and  $e_m$  are the exchange rates applied to exporters and importers respectively;  $t_{Ei}$  and  $t_{Mi}$  are tariffs imposed on exports and imports respectively;  $s$  is export subsidies while  $r$  refers to other export incentives;  $n$  is import surcharges while  $p$  refers to other import restrictions.  $P^s / P^d$  is the relative prices index as US CPI to domestic CPI (Edwards 1989a, p. 7; Sadoulet and de Janvry 1995, p. 214).

It is inappropriate, for the reason mentioned above, to use the official nominal exchange rate to calculate China's REER. Instead, China's REER needs to be constructed following a multiple-step process which contains (1) compiling the AERs for exports and imports, (2) estimating EERs, and (3) calculating REER. While constructing the applied exchange rate,

the fact was that this rate was the mixed one which combined both the official (not always the nominal but also the one called “internal”) exchange rate and the “swap rate”. This was achieved by a weighted combination of the official nominal rate and the swap rate. The weights of the swap rate were determined as 0.28 for 1980-1986, 0.44 for 1987-1990 and 0.80 for 1991-1993.<sup>[6]</sup> Official nominal rates were taken for 1976-1979 and 1994-1997. Regarding the estimation of EERs, export taxes can be ignored because they were rarely used and had almost no effect on  $EER_x$ . Besides this, what can be done here is to include subsidies in  $EER_x$  and tariffs in  $EER_m$  while other factors have to be omitted, due to the lack of information. Finally,  $EER_x$  and  $EER_m$  were combined with weights of exports and imports to form an aggregate EER. Then, EER was adjusted with  $P^s/P^d$  index to form China’s REER. Note that China has only published the data of general consumer prices index for the period since 1985. To cover a longer period, there is only a set of CPI in urban areas available. However, the difference of figures between the general CPI and the urban CPI are quite large, in some compatible years urban CPI was 20% higher than the general CPI. Thus there is a danger that the use of urban CPI data is likely to undermine China’s REER and affect the results of the cointegrating regressions. Another weakness may be that the constructed REER has not included non-tariff factor. But in the sense of evaluating the effects of exchange rate policy on foreign trade it is necessary to measure the effects of REER on trade.

Nonetheless, given the nature of the above process of data construction, regressing exports or imports on these different exchange rates separately can just show the effects of related policy. For example, the difference between the nominal and applied rates was the function of the swap rate, acting as “other incentive” ( $r$ ) to exporters and as “import surcharge” ( $n$ ) to importers, implying the effects of the foreign exchange retention policy. Similarly, the difference between the applied rate and EERs demonstrated the effects of subsidies on exports ( $s$ ) and tariffs on imports ( $t_M$ ).

### 6.2.2 Results of the Cointegration Test

Following the proposed procedure, the stationarity of each series has been tested for by applying Augmented Dicky-Fuller (ADF) test for unit root. Critical values are obtained from running *Microfit 4.0* in which the 95% critical values (or say, at 5% significance level) are computed in the process of ADF test, for any sample size, using the response surface

estimates given in Mackinnon (1991). The results given in Table 6.5 display the statistical properties for each series. The levels of all series are nonstationary. That ADF statistics are significant for the first-difference series suggests all these series appear to be I(1) and cointegrating relationships may exist between appropriate variables.

**Table 6.5 Unit Root Tests for Variables of Trade and Exchange Rate**

Variables (in logarithms)	Levels			First difference		
	Test statistic	Feature of test	Critical value	Test statistic	Feature of test	Critical value
LX	-1.0149	Y, N, 1	-3.0199	-3.2642	Y, N, 1	-3.0294
LM	-1.9041	Y, N, 1	-3.0199	-4.2412	Y, N, 1	-3.0294
LOER	-0.1292	Y, N, 1	-3.0199	-3.2365	Y, N, 1	-3.0294
LAER	-0.7121	Y, N, 1	-3.0199	-3.6341	Y, N, 1	-3.0294
LEERX	-0.8229	Y, N, 1	-3.0199	-4.2367	Y, N, 1	-3.0294
LEERM	-1.0796	Y, N, 1	-3.0199	-3.9258	Y, N, 1	-3.0294
LX	-3.2372	Y, Y, 2	-3.6746	-5.4399	Y, Y, 4	-3.7347
LM	-3.4062	Y, Y, 2	-3.6746	-4.3113	Y, Y, 1	-3.6746
LREER	-1.5403	Y, Y, 1	-3.6592	-4.3973	Y, Y, 1	-3.6746

Note: Feature of test indicates whether intercept, time trend and lags have been used in the ADF regression, marked as Y for included, N for excluded and numbers for lag(s) in use.

As explained earlier, the constructed data for exchange rates contain different information of trade policies. Cointegrating regressions have therefore been run by regressing exports (LX) on nominal exchange rate (LOER), actual exchange rate applied to exports and/or imports (LAER), effective exchange rate for exporters (LEERX) and real effective exchange rate (LREER) separately. Similar regressions have also been performed by regressing imports (LM) on different exchange rates (effective exchange rate is LEERM). Regression results are given in the left part of Table 6.6.

Looking at the results of cointegrating regressions, a preliminary conclusion is suggested. That is, there was a significant exchange rate influence on exports and imports. For example, the coefficients in equation 6-15 show that every 1% change of EER for exporters (devaluation) induced change of exports (increase) of 1.68% in the sample period. For all equations, the  $R^2$  and  $R\text{-bar-squared}$  statistics are good, suggesting that more than two-third of export growth can be explained by exchange rate changes. However, a common feature of these regressions is that the Durbin-Watson statistics are low. The relations between exchange rate and exports/imports expressed in the above equations need to be further confirmed, by applying the ADF regression to test the stationarity of residuals. Since the residuals must have zero mean and no time trend, the ADF test for residuals is to



regress the change in the residuals on its own lag and a lagged difference term(s). Specifically, equation of the ADF test for residuals is written as:

$$\Delta u_t = \sigma_1 u_{t-1} + \sum_{i=1}^k \sigma_{2i} \Delta u_{t-i} + \mu_t \quad (6-10)$$

where  $u$  denotes the residuals from the cointegrating regressions while  $\mu$  is the new error term of this regression. To confirm the relations between exchange rate and exports/imports as in the estimated equations, two criteria need to be achieved. The first is that the new error term is necessarily led close to white noise (i.e., DW statistic  $\approx 2$ ), proving the removal of residual autocorrelation. The other is the  $t$ -value for coefficient of lagged residuals ( $\sigma_1$ ) needs to be greater than the ADF critical value, showing the stationarity of the residuals.

**Table 6.6 Cointegrating Regressions**

Cointegrating Equations ( $t$ -statistics in parentheses)	Other Statistics			Stationarity Test for Residuals ( $t$ -statistics in parentheses)	Other Statistics			
	R <sup>2</sup>	RBS	DW		RBS	DW	F	
$LX = 1.81 + 1.50LOER$ (10.96) (12.33)	0.88	0.88	0.41	$\Delta u_t = -0.49u_{t-1} + 0.49\Delta u_{t-1}$ (-4.03) (3.19)	0.53	2.27	22.71	(6-11)
$LM = 1.93 + 1.41LOER$ (11.00) (10.92)	0.86	0.85	0.52	$\Delta u_t = -0.65u_{t-1} + 0.32\Delta u_{t-1}$ (-4.67) (2.11)	0.54	2.07	22.90	(6-12)
$LX = 1.52 + 1.55LAER$ (9.46) (14.35)	0.91	0.91	0.82	$\Delta u_t = -0.80u_{t-1} + 0.43\Delta u_{t-1}$ (-3.86) (2.27)	0.42	2.20	14.55	(6-13)
$LM = 1.66 + 1.46LAER$ (9.47) (12.44)	0.89	0.88	0.85	$\Delta u_t = -0.91u_{t-1} + 0.54\Delta u_{t-1}$ (-5.63) (3.64)	0.63	2.58	33.28	(6-14)
$LX = 1.35 + 1.68LEERX$ (9.69) (17.75)	0.94	0.94	0.77	$\Delta u_t = -0.78u_{t-1} + 0.56\Delta u_{t-1}$ (-4.45) (3.35)	0.53	2.06	22.27	(6-15)
$LM = 1.32 + 1.65LEERM$ (8.67) (16.35)	0.93	0.93	0.99	$\Delta u_t = -1.02u_{t-1} + 0.64\Delta u_{t-1}$ (-6.49) (4.62)	0.70	2.59	45.18	(6-16)
$LX = 0.79 + 2.05LREER$ (1.84) (6.88)	0.70	0.69	0.28	$\Delta u_t = -0.10u_{t-1} + 0.27\Delta u_{t-1} - 0.03\Delta u_{t-2}$ (-0.56) (1.02) (-0.10)	-0.08	2.02	0.33	(6-17)
$LM = 0.89 + 2.00LREER$ (2.25) (7.30)	0.73	0.71	0.49	$\Delta u_t = -0.22u_{t-1} + 0.28\Delta u_{t-1} - 0.19\Delta u_{t-2}$ (-0.97) (1.14) (-0.72)	0.07	2.09	1.64	(6-18)

Note: RBS = R-bar-squared. Significance level is 5% except equations 6-17 and 6-18.

The results of residuals tests given in the right part of Table 6.6 show that the long-run relationships have not been found between REER and exports/imports. The reason may be that the data used has been affected by the incomplete transformation due to the non-availability of appropriate CPI for China, as already mentioned. From the remaining equations, cointegrating relationships between exchange rate and trade performance have been confirmed, given that the  $t$ -statistics for the lagged term of residuals are greater than

the associate ADF critical value (3.6765 for the same sample size at 5% significance level, obtained from running *Microfit* 4.0).

As expected, the results for the regression of exports (or imports) on the various exchange rates are different, as seen by the coefficients of the different exchange rate in the equations. Recalling the nature of the data constructions, these results suggest that some other trade policies, rather than nominal exchange rate alone, have undeniable effects on China's trade performance. Approximately, the difference between the coefficients of official nominal exchange rate (OER) and applied exchange rate (AER) indicates the effects of the foreign exchange retention policy. These effects occurred as the retained foreign exchange was allowed to be converted into the domestic currency at a higher rate (swap exchange rate). This policy provided an export incentive to exporters but acted as a surcharge to importers. However, while the effects of AER on exports have been certain, the change of exchange rate (the increase of the domestic price of foreign exchange) did not lead to reduction of imports. Explanations may be that: First, China's imports had a feature of "import hunger" and a special structure towards import substitution, which resulted in high import demand. Second, for many years in the sample period, the devaluation of the *Renminbi* was not large enough to be restrict to imports. In China, the main restrictions on imports were the NTBs, not the exchange rate.

Similarly, the difference between coefficients of AER and EERs shows the effects of subsidy and tariff policies. Export subsidies and domestic subsidies enjoyed by the trade sectors seemed a stronger incentive to promote export growth: The coefficient of exchange rate increased from 1.55 (for AER) in equation 6-13 to 1.68 (for  $EER_x$ ) in equation 6-15. On the import side, again, unlike exports, exchange rate could not be said to be the determining factor in import demand. Although the relation between imports and  $EER_m$  contains the effects of tariff reduction in the 1990s, the full explanation for the import increase is likely to rely on factors other than exchange rate alone.

Given the above discussion, the following analysis concentrates on the export side. The result of the above cointegrating regression has proven the existence of long-run cointegration relationship between exchange rates (OER, AER and  $EER_x$ ) and exports. That is, as general trend in the sample period, export growth was closely related to the change of

exchange rate. However, exchange rate policy and other export policies did not change equally each year during the period. In particular, some trade policies were effective only temporarily. As a result of policy changes, exports also fluctuated drastically throughout the reform period. An error correction model (ECM) could provide the necessary information for explaining the move of exports from short-run fluctuations to the level of long-run equilibrium. By applying equation 6-5, the extent to which export growth derives from its long-run relationship with exchange rate is contained in the following ECMs.

**Table 6.7 The Error Correction Models Based on Cointegrating Regressions**

ECMs ( <i>t</i> -statistics in parentheses)	R <sup>2</sup>	RBS	DW	RSS	F	
$\Delta LX_t = 0.10 - 0.22ecm_{t-1} + 0.33\Delta LX_{t-1} + 0.24\Delta LOER_t$ (2.16) (-2.88)      (-1.54)*      (1.28)**	0.37	0.26	2.11	0.11	3.22	(6-19)
$\Delta LX_t = 0.17 - 0.18ecm_{t-1} + 0.25\Delta LX_{t-1} - 0.34\Delta LAER_{t-1} - 0.25\Delta LAER_{t-2}$ (3.66) (-1.62)*      (1.09)**      (-2.51)      (-1.76)	0.41	0.24	2.07	0.10	2.41	(6-20)
$\Delta LX_t = 0.17 - 0.19ecm_{t-1} + 0.28\Delta LX_{t-1} - 0.19\Delta LEERX_{t-1} - 0.52\Delta LEERX_{t-2}$ (4.31) (-1.54)*      (1.32)**      (-1.14)**      (-3.01)	0.48	0.33	2.14	0.09	3.17	(6-21)

Note: Significance level is 5% except that \* denotes at 10% level while \*\* at 15% level.  $ecm_{t-1}$  in each equation is lagged residuals from the corresponding cointegrating regression. RBS = R-bar-squared. RSS = residual sum of squares.

In establishing the ECMs, the adopted method is to include several lagged terms on the right-side of the equation in regression and then delete the insignificant term individually. Meanwhile, regressions are required to achieve the approximate white noise of the new error terms. The *t*-values of the coefficients of the lagged residual term ( $ecm_{t-1}$ ) are all significant at either 5% or 10% level, indicating that the coefficients are not zero. Further, while regressing exports on lagged exchange rate, the statistical significance that all coefficients are not zero also leads to a conclusion that exchange rate Granger causes exports. These results show that the fluctuations of China's exports can be explained by the changes of the exchange rate, as well as the changes of exports itself, in proceeding years. The coefficients of the lagged residual term ( $ecm_{t-1}$ ) indicate the extent of correction needed. Note that, in the ECMs, the explanation of export growth seems more dependent on the change of exchange rate than on the previous situation of exports. This fact implies that the growth of exports has very much relied on the change in the exchange rate — devaluation of the *Renminbi*.

When the cointegration relationship between exports and exchange rate and the corresponding ECM have been established, it is interesting to identify how these estimates have imitated the real situation in China. A simple way is to add dummy variable into the

ECM to test the established relationship. To represent the trade policy change in a specific year which was excluded from the construction of the exchange rate, a dummy variable is set at a magnitude of one in the year, otherwise zero. If the ECM remains unchanged when the dummy variable is added, the conclusion will be that the trade policy change represented by the dummy variable was working within the established cointegration relationship and the ECM is appropriate even when the new variable has been considered. Otherwise, there will be a different relationship between exports and exchange rate when a new variable is added.

Since the duty drawback policy has not been included in the process of the data construction, now let dummy variables DUM85, DUM94 and DUM96 represent the beginning of this policy and the adjustments of duty drawback rates.<sup>[7]</sup> Broadly, the dummy variables represent all policy changes in the year. However, most factors (for example, two adjustments of nominal exchange rate in 1985, the unification of exchange rates in 1994) have been included in the constructed exchange rates. In this sense, these dummy variables could approximately represent the effects of the duty drawback policy. Table 6.8 reports the testing results.

**Table 6.8 Testing the ECMs Using the Dummy Variables**

Variables	(6-22)		(6-23)		(6-24)		(6-25)		(6-26)		(6-27)		(6-28)		(6-29)	
	coef.	t	coef.	t	coef.	t	coef.	t	coef.	t	coef.	t	coef.	t	coef.	t
constant	0.09	2.05	0.10	2.46	0.18	4.29	0.17	4.50	0.17	6.95	0.18	5.12	0.16	5.33	0.16	5.23
ecm <sub>t-1</sub>	-0.23	-3.11	-0.22	-3.35	-0.18	-1.80	-0.14	-1.60*	-0.13	-2.09	-0.18	-1.63*	-0.20	-2.11	-0.18	-1.91
DLX <sub>t-1</sub>	0.39	1.86	0.41	2.22	0.23	1.13**	0.25	1.41*	0.31	2.51	0.27	1.46*	0.36	2.24	0.41	2.58
DLEERX <sub>t-1</sub>											-0.22	-1.48*	-0.23	-1.83	-0.28	-2.24
DLEERX <sub>t-2</sub>											-0.54	-3.54	-0.56	-4.36	-0.46	-3.21
DLAER <sub>t-1</sub>					-0.36	-2.95	-0.35	-3.20	-0.38	-5.24						
DLAER <sub>t-2</sub>					-0.28	-2.14	-0.30	-2.66	-0.29	-3.79						
DLOER <sub>t</sub>	0.35	1.82	0.30	1.74												
DUM85	-0.14	-1.67*	-0.14	-1.89	-0.15	-1.94	-0.14	-2.14	-0.16	-3.52	-0.16	-2.13	-0.14	-2.42	-0.15	-2.59
DUM94							0.16	2.23	-0.16	3.28			0.16	2.63	0.16	2.64
DUM96			-0.16	-2.19					-0.19	-4.05					-0.10	-1.39*
R <sup>2</sup>	0.47		0.60		0.54		0.68		0.87		0.61		0.75		0.79	
RBS	0.33		0.49		0.36		0.51		0.79		0.46		0.63		0.66	
RSS	0.09		0.07		0.08		0.05		0.02		0.06		0.04		0.03	
DW	1.93		1.78		2.24		2.18		1.93		2.47		2.25		2.08	
F	3.39 (4, 15)		4.35 (5, 14)		3.06 (5, 13)		4.17 (6, 12)		10.49 (7, 11)		4.09 (5, 13)		6.11 (6, 12)		5.92 (7, 11)	

Note: Due to the use of different lags, equations 6-24 to 6-29 are valid for the period of 1979-1997 while equations 6-22 and 6-23 for 1978-1997. In the table, "coef." refers to coefficients and "t" refers to t-statistics. Significance level is 5% except that \* denotes at 10% level while \*\* at 15% level.

Results in the above table show that DUM85, DUM94 and DUM96 were working well within the established cointegration relationship between exports and exchange rate and improved the capacity of the model to explain the increase of exports. The conclusion

implied is that the duty drawback policy, as other factors included in the constructed AER and  $EER_x$ , have effectively contributed to China's export growth. In addition, since the ECMs have remained effective when the dummy variables have been added, it is reasonable to consider the present established cointegration relationship and the ECMs, although not perfect, the ones reflecting the real situation.

To sum up, the econometric modelling in this section has shown that the changes of China's trade policy in the reform period have been effective, especially on the side of export policies. Recalling the facts that export subsidies, the foreign exchange retention system and the dual exchange rates system have been ended one after another, it is obvious that China's export incentives now mainly rely on the exchange rate and duty drawback system. The proven positive function of China's exchange rate policy and duty drawback system on export promotion became increasingly important. Such a change of export policy is in the right direction and also evidence of China's success in trade policy reform.

### **6.3 TRADE POLICY REFORM AND ECONOMIC GROWTH**

#### **6.3.1 Empirical Studies on Trade and Growth**

The relationship between foreign trade and economic growth has long been a controversial topic among economists. The free trade theory as an orthodoxy is founded on the basis that developing foreign trade is considered one of the important approaches to increase national welfare, improve the allocative efficiency of resources and therefore promote economic growth. Trade liberalisation in the post-war period and trade policy reform since the 1980s also reflected the recognition of the issue that trade expansion could be an important source to economic growth.

The positive relationship between trade (exports) and growth/development is also supported by a number of empirical studies. Among them, some influential results from various approaches of testing can be found, for example, in Michaely (1977), Balassa (1978, 1982), Feder (1983, 1985), Chow (1987) and Ram (1987).

However, although the view that trade positively contributes to economic growth has never lacked theoretical explanation and is widely accepted by economists, some still argued that it is not appropriate to overestimate the role of trade in the process of growth. The reasons are that, first, there is no systematic pattern, neither positive nor negative,

between trade and growth. The historical record provides no conclusive evidence of trade working as an engine of past economic growth. Favourable world market conditions and appropriate trade policy can help, but are neither necessary nor a sufficient condition for economic development to take place (Sundrum 1990; Pomfret 1991). Second, trade does not create a wholly new type of situation as far as economic growth is concerned. The effect of trade on growth will depend on how much a country gains from trade (Chaudhuri 1989). By carrying out econometric test, Jung and Marshall (1985) in their study show that the correlations between exports and growth found in other previous studies were spurious.

In recent years, there has been an increasing interest in exploring the relationships between trade and growth. In some studies, especially those based on cases of East Asian export-led growth, the positive relations between trade and growth were confirmed from various standpoints. A World Bank study (1993) pointed out that the emphasis on export expansion, together with high savings and investment rates, accumulation of human capital and appropriate government interventions, was an important element in the growth strategies of the high performing Asian economies. The study asserts, by measuring the determinants of total factor productivity (TFP) growth, that “openness is consistently associated with superior TFP performance” and “both indicators of export performance [the average share of manufactured exports in total exports and the share of manufactured exports in GDP] are also consistently and positively correlated with higher rates of TFP growth” (pp. 316-326). Sengupta (1994) used the “new growth theory” to conduct an empirical study on the sources of economic growth in Asian NICs. One of the conclusions is that the role of increasing returns to scale, as emphasised in new growth theory, has been very prominent in successful Asian NICs and more so in the export-oriented sectors. Li Xing (1995) argued that international economic and trade transactions generated a “tutor-pupil” relationship which created a catching-up effect. With the transfer of technology and management to them, East Asian economies strengthened their capacity to grow.

The relationship between trade and growth was also examined at a more general level. Lee and Cole (1994), in their empirical study based on extensive cross-country data, concluded that exports promote economic growth. Their result also suggested that exports probably play a more important role in the growth process than was previously indicated in a number of other studies. Drucker (1994) indicated that, by reviewing the experience of the last 40 years, increased participation in the world economy has become the key to domestic

economic growth. This lesson is not unique to Asian economies but is also the same for the developed world. Kitson and Michie (1995) constructed a data series from 1870 through 1990 and found that there are constantly high correlation statistics between world output and trade, both for levels and growth rates. Some other studies, in the context of trade policy reform, also confirmed the positive relationship between trade and growth (for example, Thomas *et al* 1991; Papageorgiou *et al* 1991; Kawai 1994; Ghani and Jayarajaj 1995; Shafaeddin 1995).

The contrary conclusions from different studies on the same theme of the relationship between trade and growth presented the following two sets of problems. First, the relationship between trade and growth may vary from country to country, due partly to the existing economic structure and partly to the development strategy in an individual country. Specifically, whether there is an effective mechanism by which a country's comparative advantage and the resulting gains from trade can be transformed into powers of growth (in forms of investment increase and efficiency improvements) may be crucial in affecting the relationship between trade and growth. A generalised steady pattern of the relationship between trade and growth, if any, remains to be proven. Second, as some researchers pointed out, all previous studies on the theme have been affected by the approaches used, concerning the choice of samples and estimating techniques (Edwards 1989a, pp. 25-33; Salvatore and Hatcher 1991).

With regard to the methods for the statistical investigations, there are two widely adopted ways to examine the relationship between trade and growth. One is the conventional ordinary least square (OLS) regression, regressing national output (GDP) on labour, investment and exports in sense of an augmented neo-classic production function. The exports variable is considered as a factor representing the externalities of an open economy which in turn generate favourable effects on resource allocation, economy of scale, capacity utilisation and technological change. In general, the applications of this approach have had supportive evidence in favour of export-led policies, implying the positive relationship between exports and growth (Edwards 1989a, p. 28). The other is the integration analysis developing fast in recent decades. Researchers preferring this way emphasise the quality of the data, which seems a weakness in the conventional use of OLS regression. In the past decade, many studies were carried out in this line to test the relationship between exports and growth but results varied. It is also worth mentioning that

the cointegration analysis has been described only showing whether exports change precede or follow movements in GDP (GNP), rather than a true causal relationship (Leamer 1994). There is still a need for researchers to establish the link between exports and growth.

### 6.3.2 Statistical Analysis on Exports and Growth: the Case of China

It is not the aim of this study to develop a new model for testing the relationship between exports (trade) and growth. Instead, it is the interest to apply the existing approaches to the case of China, for exploring the specific pattern of links between trade and growth in the economy. Given the above review, both conventional OLS regression and cointegration analysis are proposed to be performed in this section, using the post-reform data. Basic data are in *Yuan* and taken from *China Statistical Yearbook* (various issues). Export values are transformed in real terms of *Yuan* (deflated by China's urban CPI, 1990=100). Although data of GDP in 1990 constant price are available in the *International Monetary Statistics Yearbook*, a new set of GDP data has been created by deflating GDP in current prices by China's urban CPI. Other variables are also dealt with in the same way. By taking this measure, the levels of the variables may have been undermined, due to the fact that the urban CPI is usually higher than the general CPI. However, because of using the same deflator, the extent of the possible underestimation in absolute value for all variables is also the same, which guarantees the consistency of the data. The problem encountered in constructing the REER has not been an obstacle here. No bias or distortion has been caused in the process of data conversion.

First, cointegration analysis on the relationship between GDP and exports has been carried out in Granger sense. ADF tests for unit roots have proven both variables are  $I(1)$ , featuring nonstationary in levels but stationary in first-differences. Then, cointegrating regression and corresponding ECM have been performed. Results are summarised in Table 6.9 and Table 6.10.

**Table 6.9 Unit Root Tests for Variables of GDP and Exports**

Variables (in logarithms)	Levels			First difference		
	Test statistic	Feature of test	Critical value	Test statistic	Feature of test	Critical value
LCGDP	0.06889	Y, N, 1	-3.0401	-3.1135	Y, N, 3	-3.0819
LCXY	-1.00290	Y, N, 1	-3.0401	-5.0593	Y, N, 0	-3.0401

Note: Feature of test indicates whether intercept, time trend and lags have been used in the ADF regression, marked as Y for included, N for excluded and numbers for lag order in use. Sample period: 1978-1997.



**Table 6.10 Cointegrating Regression and The Error Correction Model**

Equations ( <i>t</i> -statistics in parentheses)		R <sup>2</sup>	RBS	DW	RSS	F	
Cointegrating regression:	$LCGDP_t = 4.81 + 0.49LCXY_t$ (51.41) (28.42)	0.98	0.98	0.97	0.10		(6-30)
ADF test for residuals:	$\Delta u_t = -0.83u_{t-1} + 0.46\Delta u_{t-1}$ (-3.1367) (1.9162)	0.38	0.34	1.92	0.06	9.80	(6-31)
ECM:	$\Delta LCGDP_t = 0.12 - 0.52ecm_{t-1} + 0.79\Delta LCGDP_{t-1}$ (0.71) (-3.67) (4.33) $+ 0.19\Delta LCXY_t - 0.19\Delta LCXY_{t-1}$ (3.83) (-3.11)	0.70	0.61	1.98	0.01	7.68	(6-32)

Note: CGDP and CXY are constructed GDP and exports in *Yuan*, respectively, as discussed in the above text.  $ecm_{t-1}$  is lagged residuals ( $u_t$ ) from the cointegrating regression (eq. 6-30). RBS = R-bar-squared. RSS = residual sum of squares. Sample period: 1978-1997. Significance level is 5%.

As shown in equation 6-30 (Table 6.10), it can be seen that there was significant cointegration relationship between exports and GDP in the sample period. But the low DW statistic called for an ADF test for residuals (equation 6-31). Regression result shows that the *t*-statistic for the coefficient of the lagged residual term is -3.1367. If an intercept has been included, the ADF *t*-statistic is -3.0825. Both are slightly greater (in absolute value) than the associated ADF critical value (-3.0401, with an intercept but without time trend). It is possible to conclude that the residuals have been proven stationary. Therefore, the cointegration regression equation could be confirmed as an acceptable expression of the positive linkage between exports and GDP. Based on the above results, the related ECM (equation 6-32) indicates that, as a long-run trend, the growth of GDP (approximated by  $\Delta LCGDP_t$ ) has been affected by the growth in exports, as well as by GDP itself.

Second, the relationship between exports and GDP also has been tested in form of conventional OLS regression. The standard model used in many studies is derived from the aggregate production function:  $Y = f(L, K, X)$ , where *Y* refers to national income (GDP), *L* is labour force, *K* is capital stock and *X* is exports. In application, estimation is usually made in form of the following equation,

$$\hat{Y} = a_0 + a_1\hat{L} + a_2IY + a_3\hat{X} \quad (6-33)$$

where  $\hat{Y}$  is annual growth rate of real GDP,  $\hat{L}$  the growth rate of labour force, *IY* the share of gross domestic investment in GDP in the preceding year (i.e.,  $I_t/Y_{t-1}$  where *Y* denotes GDP and *I* investment), and  $\hat{X}$  the growth rate of exports (Lal and Rajapatirana 1987; Edwards 1989a, pp. 25-26; Lee and Cole 1994).

Due to the data limitation, estimation has been made for China over the period of 1979-1996. The result is as following:

$$\hat{Y} = -0.24 - 0.028\hat{L} + 0.766IY + 0.107\hat{X} \quad (6-34)$$

(-2.34) (-0.05) (2.96) (2.12)

$$R^2 = 0.49 \quad RBS = 0.38 \quad F(3,14) = 4.51 \quad RSS = 0.02 \quad DW = 1.12$$

Note that, in the regression result, the *t*-statistic for the coefficient of the labour force is insignificant, indicating that GDP growth did not rely on the growth of the labour force. In contrast, *t*-statistics for both investment and exports are significant at 5% level, proving their positive contribution to the growth of GDP. Several points can be drawn from analysis of the coefficients in the equation. First, China's GDP growth seems to be of the investment-driven type. A percentage point increase in investment explains 0.77% of GDP growth, while the contribution of export growth is much lower than that of investment. This is consistent with feature of development in developing countries and with the general impression from China's statistics. In 1981-96 period, for example, China's average annual growth rate of gross domestic investment was 19.8%, higher than annual growth rate of exports (14.2%). Moreover, investment has direct effects in promoting GDP growth, while exports are only an indirect source of growth. Second, the function of exports in promoting GDP growth seems to be at a reasonable level. In some other similar studies based on the experience of developing countries, regression coefficients for exports were in a range between 0.055 and 0.160 (see Lee and Cole 1994). The coefficient of 0.107 for exports in China's case could be an acceptable explanatory factor for GDP growth. Third, the low WD statistic is another unsatisfactory aspect of the regression equation. This implies China's GDP growth may have been affected by some other factors which have not been included in the regression equation. Some researchers tried to use additional explanatory variables in the standard production function, seeking more complete specifications for explaining GDP growth. For example, Edwards (1989a, 1992) uses a number of variables, including the measure of gap of knowledge stock, index of trade intervention, index of openness and index of political instability, to modify the regression equation. Unfortunately, such an approach cannot be adopted in this study, for the reasons that constructing these indices is an expensive task and, in China's case, data for index construction are in severe shortage.

Interestingly, when equation 6-34 was re-estimated by dividing investment into domestic-funded investment and foreign investment while exports were distinguished between those from domestic-funded enterprises and those from foreign-funded enterprises, the regression result had the same basic pattern as equation 6-34. However, foreign-funded investment and associated exports were not reliable explanatory variables for GDP growth. Calculated *t*-statistics for the coefficients of these two variables are both insignificant while *t*-statistics for the coefficients of domestic investment and exports are similar to those in equation 6-34. This implies that both growth of foreign investment and growth of exports from foreign-funded enterprises did not significantly contribute to the growth rate of GDP, although they grew surprisingly fast in the late 1980s and the first half of the 1990s. To be sure, if foreign investment and associated exports have functioned as promoters of the GDP growth rate, there should be a faster GDP growth rate consistent with the rapid growth of foreign investment and exports from foreign-funded enterprises. However, such a situation does not appear. Given the fact that exports from foreign-funded enterprises accounted for about 40% of China's total exports, an conclusion implied by the above regression may be that the growth of foreign investment and associated exports have contributed significantly to China's export expansion but less to GDP growth. This is not to say that foreign investment and associated exports have made no contribution to China's economic growth. It is only indicating that no significant linkage between the growth rates of them has been found.

### **6.3.3 Approaches in Which Trade Works**

Although foreign trade (exports) is not the main source of growth, its positive function in promoting economic growth should not be underestimated. The rapid development of foreign trade enabled China to escape the constraints of extreme "self-reliance" and to be a new and important player in the world economy. Simultaneously, positive foreign trade activities induced a new path to economic development. That is to say, it accelerated domestic economic growth by increasing the extent of foreign involvement in the economic process and by utilising overseas resources, technology and markets. Specifically, trade (exports) expansion created impacts on GDP growth by improving efficiency of resource allocation and increasing total factor productivity.

### *Efficiency of Resource Allocation*

The significance of foreign trade development in economic growth has two major aspects: technological progress and market expansion. Both have effects on the improvement of resource allocative efficiency. On the import side, growth of productive materials and technology imports enables a country to produce some goods that could not be produced earlier, or to reduce the cost of products by using the more efficient production approach. The surplus capital can then be used to expand production by reinvestment. On the export side, the part of GDP growth resulting from the growth of exports is mainly due to the fuller utilisation of existing productive capacity. Export growth promotes the growth of productive capacity by inducing faster technological progress, with the aim of competing with other producers in world markets. The growth of exports leads to the growth of productive capacity by expanding the opportunities for profitable investment or increasing return of economic scale. To take the advantage of the fact that trade expansion improves economic performance, it is essential to liberate trade from various restrictions.

In the case of China, the change of trade policies loosened the tremendous potential for developing the national economy. First, opening the country to foreign investment has filled in the gap in capital within the country. Most of these foreign investments, in the forms of imported equipment and productive materials, were used to establish new production and services entities, or to improve the production conditions of existing enterprises. Both activities may increase total GDP. Second, China's export income was mainly used for the imports of capital goods, especially machinery and equipment and some raw materials. The logic is that exporting served to finance import requirement, the final aim being to strengthen the capacity of the nation's production and to meet the need to improve the standard of people's life. So the development of foreign trade, on both sides of export and import, is closely concerned with national economic growth. Third, the expansion of the export sector induced related industries to increase the size of production. Fourth, some advanced, and appropriate, technologies were introduced into the economy in the process of utilising foreign capital and of importing equipment and assembly lines. This has accelerated the industrialisation of the country and eventually enhanced the technology levels on both ranges of enterprise and of sectors.

### **TFP Effect**

Improved efficiency of resource allocation can be reflected in GDP growth resulting from those factors other than increases in capital and labour forces inputs. Total factor productivity (TFP), showing the overall improvement of resource utilisation, is defined as “a residual of output change obtained by subtracting the changes in inputs from output changes” (Urata 1994). Export expansion will raise TFP by virtue of the favourable effects on resource allocation, capacity utilisation, technological upgrade and economies of scale.

In the simplest way, the measurement  $TFP = Y/L^\alpha K^{1-\alpha}$  can be rewritten as

$$TFP_t = \text{EXP}[\ln Y_t - \alpha \ln L_t - (1-\alpha) \ln K_t] \quad (6-35)$$

where  $Y$ ,  $L$  and  $K$  are output (GDP), labour force input and capital input, respectively.

The calculated TFP in fact contains the effects of technological changes. Put it in another way, the effect of technological changes indicates the improvement of total factor productivity (TFP). Measurement of technological changes can be derived from an aggregate production function  $Y = Ae^{rt} L^\alpha K^{1-\alpha}$  in logarithm form as

$$\ln Y = \ln A + rt + \alpha \ln L + (1-\alpha) \ln K \quad (6-36)$$

where  $Y$ ,  $L$  and  $K$  are output (GDP), labour force and capital, respectively;  $A$  is constant term;  $t$  is time trend and  $r$  represents the contribution of technological changes on the growth of  $Y$ . Differentiating the equation, we have

$$\frac{dY}{Y} = r * dt + \alpha \frac{dL}{L} + (1-\alpha) \frac{dK}{K} \quad (6-37)$$

Approximating the differentiated equation into difference equation where  $\Delta t = 1$  when annual data are used:

$$\frac{\Delta Y}{Y} = r + \alpha \frac{\Delta L}{L} + (1-\alpha) \frac{\Delta K}{K} \quad (6-38)$$

$$\text{or} \quad r = \frac{\Delta Y}{Y} - \alpha \frac{\Delta L}{L} - (1-\alpha) \frac{\Delta K}{K} \quad (6-39)$$

In computing TFP and the technological change  $r$ , a crucial step is to determine the output elasticity of labour and capital inputs. For convenience, directly observed factor share(s) can be used as approximate measures of these elasticities to estimate TFP growth. By adopting an estimated factor share for labour income in China for the period of 1979-1994,  $\alpha = 0.453$ , from Hu and Khan (1997), we calculated China's growth of TFP and  $r$  for the period of 1979-1996, based on unadjusted aggregate data as used above. Results from the calculation show that, in 1979-1996, the average rate of TFP growth was 2.66%. The contribution of technological changes ( $r$ ) to GDP growth increased from 26.32% in 1979 to 43.13% in 1995 (and 41.94% in 1996).

**Table 6.11 Average Annual Growth Rates of GDP and TFP (%)**

	GDP		TFP			GDP		TFP	
	1970-80	1980-90	1970-80	1980-90		1970-80	1980-90	1970-80	1980-90
Asia					Latin America				
Korea	8.3	8.9	0.8	2.8	Chile	2.5	2.8	0.5	-0.1
Taiwan	9.3	7.4	5.1	3.9	Argentina	2.6	-1.2	0.1	-1.6
Singapore	8.6	6.8	0.7	1.6	Mexico	6.4	1.6	1.1	-2.1
Thailand	6.5	7.5	1.2	2.6	Brazil	8.2	1.5	0.4	-1.9
Malaysia	7.6	5.8	2.5	0.7	Colombia	5.3	3.4	0.8	0.4
Indonesia	7.0	5.5	3.1	-0.1	Peru	3.7	-1.1	0.3	-3.0
Philippines	5.7	1.6	0.8	-2.2	Venezuela	3.1	0.7	-2.4	-0.6
India	3.0	5.4	-0.9	2.1					
China	6.0	8.3	1.1	2.8					

Source: Kawai (1994).<sup>[8]</sup>

**Table 6.12 Sources of China's Economic Growth (%)**

	<u>Li &amp; Li's estimate</u>		<u>Hu &amp; Khan's estimate</u>		
	1952-79	1979-90	1953-94	1953-78	1979-94
(1) value added (growth)	5.96	8.35	7.2	5.8	9.3
(2) capital input growth	5.48	4.27	6.8	6.2	7.7
(3) labour input growth	1.19	1.55	2.6	2.5	2.7
(4) productivity increase (TFP)	-0.71	2.53	2.1	1.1	3.9
(2)/(1) contribution of capital input to growth	92.00	51.00	55.6	65.2	45.6
(3)/(1) contribution of labour input to growth	20.00	18.50	14.9	16.8	12.8
(4)/(1) contribution of productivity to growth	-12.00	30.29	29.5	18.0	41.6

Source: Li Jinwen and Li Jun (1993); Hu and Khan (1997).

Some other estimates of China's TFP growth are listed in Tables 6.11 and 6.12. Note that there are differences in these estimates, due to their adoptions of different approaches. The most important feature is that all these estimates have a common identity showing the positive role of improved productivity in transforming China's economy.

Table 6.11 shows the economic performance in terms of GDP and TFP growth in some Asian and Latin America countries, based on 1970-1990 data. As can be seen, for the

period of 1980-90, China recorded a high GDP growth rate, as well as Korea, Taiwan and Thailand, and also registered a high TFP growth rate. Table 6.12 shows that, after reform, the factor of technological progress (represented by the rate of TFP) has made a much bigger contribution to economic growth. According to Li Jinwen and Li Jun's estimate, the average annual rate of economic growth between 1979 and 1990 was 8.35%, 2.39 percentage points higher than that of 1952-1979. The growth rate of productivity has been turned from negative (-0.71%) to positive (2.35%), increasing by 3.24% per year. The contribution of productivity growth to economic growth reached 30.29% during 1979-1990. Hu and Khan's estimate seems much stronger, suggesting that TFP growth contributed 41.6% of the output growth in the period 1979-1994 while average annual TFP growth rate increased from 1.1% in 1953-78 to 3.9% in 1979-94. Hu and Khan state more directly that "the opening up to foreign trade and investment, the gradual price decontrol, the rise of rural township and village enterprises (TVEs), and the expansion of new private businesses brought competitive forces into the Chinese economy and helped make the economy more efficient during the reform period" (Hu and Khan 1997).

Of course the growth in TFP is attributed to a number of factors. Trade expansion is only one of these factors. However, it is also worth noting that a feature of China's economy in the reform period was that the growth of foreign trade surpasses the growth of gross domestic production. The rapid growth of the export sector implies the increasing importance of the external market to output growth. The intensive competition in the world market required exporters to improve the quality of their products, as well as to reduce the cost of those products. In such circumstances, the increase of TFP became the key point of enterprises' further development. So most Chinese exporters made a great effort to meet the challenge of the market, shifting from domestic markets to international markets. Consequently, with the progress of technology, TFP has been gradually increased in most industries. Technological progress has made a significant contribution to industrial development and to the growth of the national economy.

#### 6.4 CONCLUSION

With statistical and econometric evidence, this chapter shows that China's trade policy reform has so far been effective and become a source of China's fast economic growth. In order to carry out the econometric test, great effort has been made to construct data series. Regarding the analytical method, regressing exports on different exchange rates is also a

significant attempt to make better use of cointegration analysis in testing the relationships between trade and exchange rate based on the case of China. In particular, the constructed data successfully identified the policy factors consist in the different exchange rates and enabled the author to evaluate the effects of some of different kinds of trade policies including foreign exchange retention, subsidies and tariffs, rather than simply testing the official exchange rate.

Based on the above analysis, China's experience could be considered to support the view that trade may positively contribute to economic growth. From the standpoint of neo-classical theory, China has, through the process of opening up toward the outside world, developed her comparative advantage in order to increase export earnings. Increased income of foreign exchange has helped China to introduce foreign investment and advanced technology into the economy. The expanded access to foreign resources for the increasing investment and production has therefore been a contributing factor leading to rapid economic growth. In the view of new growth/trade theory, which stresses the role of openness in trade and export externalities as positive factors in promoting long run growth, China has also enjoyed the benefits of openness in trade and export externality. Foreign trade has been the channel through which foreign advance technology and equipment were introduced and diffused across other sectors. Not only the export sector but also other sectors have had the capacity of their productive technology enhanced. The increase in TFP showed the real growth of the economy, which was partially due to the development of foreign trade promoted by the sustained trade policy reforms.

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<sup>[1]</sup> About the *Atlas* method, a technical note in *World Development Report 1996* explains it as follows:

"The *Atlas* conversion factor for any year is the average of a country's exchange rate (or alternative conversion factor) for that year and its exchange rates for the two preceding years, after adjusting them for differences in rates of inflation between the country and the G-5 countries (France, Germany, Japan, the United Kingdom, and the United States). The inflation rate for G-5 countries is represented by changes in the SDR deflators. This three-year averaging smoothes annual fluctuations in prices and exchange rates for each country. The *Atlas* conversion factor is applied to the country's GNP. The resulting GNP in US dollars is divided by the midyear population for the latest of the three years to derive GNP per capita." (World Bank 1996, p. 236)

For details of the formulas for computing the conversion factor and calculating GNP per capita, see the Technical Notes, *World Development Report 1996* (World Bank 1996, p. 236).

<sup>[2]</sup> As the World Bank recognised, the main obstacles in using the *Atlas* method are, first, the differences in national accounting and demographic reporting systems and in the coverage and reliability of underlying statistical information among various countries and, second, the use of official exchange rates for converting GNP data from national currencies to the US dollar (World Bank 1994b, p. 231).



[3] It does not mean an official adoption of the PPP method. The World Bank itself has recognised that the *Atlas* method associated with exchange-rate conversion estimate has numerous shortcomings causing an incomparability between countries. The main obstacles in using the *Atlas* method are, first, the differences in national accounting and demographic reporting system and in the coverage and reliability of underlying statistical information among various countries and, second, the use of official exchange rates for converting GNP data from national currencies to the US dollar (World Bank 1994b, p. 231). Because of the unrealistic exchange rate, traditional method tends to underestimate China's GDP or GNP. On the other hand, the PPP method is relying on a comparable price system. Since there are still severe distortions in China's price system, It is also difficult to compare the real purchasing power between China and other countries.

[4] Cheng Huifang uses the concept "relative export performance"(REP) but the equation for calculation is the same as that of RAC. The results of Cheng Huifang's calculation are as the following:

*China's REP Index (1953-1990)*

	1953	1955	1965	1970	1975	1985	1986	1987	1988	1989	1990
Primary exports	130	124	125	150	130	140	126	118	112	106	96
Manufactured exports	50	72	84	72	75	82	94	96	100	104	118

Source: Cheng Huifang (1995).

[5] This condition is necessary for bivariate cointegration analysis but not for multivariate regression. see Mukherjee et al. (1998), p. 406.

[6] The weights 0.44 for 1987-1990 and 0.80 for 1991-1993 are taken from an IMF paper (Khor 1994). The weight 0.28 for 1980-1986 is estimated by the author, based on the fact that the total foreign exchange retention in 1980-1986 was US\$46.7 billion, accounting for 27.9% of foreign exchange income in the period (Song Hai 1988), and on the following considerations that (1) holders of retained foreign exchange might be allowed to sell their foreign exchange to others; and (2) all this retained foreign exchange would be, legally or illegally, transformed to importers because the demand for foreign exchange was always greater than supplies. Therefore, it is reasonable to assume that swap rate could be applied to this part of foreign exchange.

[7] Although the duty drawback rate was cut down in 1995 which should be an unfavourable measure to export promotion, exports however increased at an uneven growth rate in the year. This strange phenomenon was due to the flexible measures adopted in practising this adjustment and to the exporters' reflections to the other coming adjustment in 1996. Exporters made the greatest effort to increase exports before the end of 1995, to get the unchanged high rate of duty drawback. Therefore, it is inappropriate to set a dummy variable for 1995.

[8] The method to calculate TFP is described by Kawai as follows:

The growth rate of TFP as defined by the ratio of total output to total input is given by:

$$\frac{d \ln TFP}{dt} = \frac{d \ln GDP}{dt} - V_L \frac{d \ln L}{dt} - V_K \frac{d \ln K}{dt},$$

where:  $GDP$  = GDP in real term;  $L$  = labour input;  $K$  = capital input;  $V_L$  = labour share in value added;  $V_K$  = capital share in value added, and  $t$  = time.

Therefore, the growth rate of GDP is given by:

$$\frac{d \ln GDP}{dt} = V_L \frac{d \ln L}{dt} + V_K \frac{d \ln K}{dt} + \frac{d \ln TFP}{dt}.$$

which can be broken down into three factors: (1) labour contribution, (2) capital contribution, and (3) TFP contribution. (see Kawai 1994)

In computation, both of these equations may be approximately rewritten by replacing the differentiated terms with their first-differencing terms. For example, the growth rate of TFP can be calculated using the following equation:

$$\ln TFP(t) - \ln TFP(t-1) = \ln GDP(t) - \ln GDP(t-1) - V_L [\ln L(t) - \ln L(t-1)] - V_K [\ln K(t) - \ln K(t-1)],$$

as used in this chapter.

## 7 China's Trade Policy Reform in International Context

The aim of the open-door policy is to connect the Chinese economy with the outside world. Apart from its domestic aspects, China's trade policy reform was unavoidably affected by its external environment on the one hand, and simultaneously had an important impact on international economy on the other. It was the increasing importance of China that attracted wide attention from international society. Various responses from different countries encouraged and/or pressed China to reform its trade policies. This chapter intends to examine China's linkages with world trade, and with some specific countries and areas.

### 7.1 CHINA AND THE WORLD ECONOMY

Since the adoption of the open-door policy, the promotion of external trade and economic co-operation with other countries has been one of the central tasks for China. From 1979 to 1997, as mentioned in Chapter 1, China's average annual growth rate of foreign trade was 15.61%. Compared with other countries, China's foreign trade development has been impressive (Table 7.1).

**Table 7.1 Average Annual Growth Rate of Exports (%)**

	World	USA	Japan	HK	Korea	Singapore	Taiwan	Malaysia	China	Brazil
1978-90	8.66	8.62	9.37	17.85	14.56	14.74	14.93	12.17	16.48	7.87
1990-96	7.63	8.01	6.13	14.04	12.20	15.47	9.50	17.71	15.99	7.23
1978-96	8.32	8.42	8.28	16.56	13.77	14.98	13.09	13.99	16.32	7.66

Source: IMF (1997).

**Table 7.2 China's Share in World Total Exports**

	1978	1980	1985	1990	1992	1994	1995	1996
World total exports (US\$ billion)	1297.4	1990.6	1927.7	3470.0	3700.0	4168.3	5033.0	5270.0
China's exports (US\$ billion)	9.75	18.12	27.35	62.09	84.94	121.04	148.77	151.1
The rank in world exporters	32nd	26th	17th	15th	11th	11th	11th	11th
Share in world exports (%)	0.75	0.91	1.41	1.79	2.30	2.90	3.00	2.90

Source: The Editorial Board (1995), p. 404; WTO (1996), Vol. II, p. 3; WTO (1997), Vol. II, p. 3.

The effect of the rapid foreign trade growth enabled China to become a major player in the world economy. In 1996, China was for the fifth year ranked 11th in world trade. As shown in Table 7.2, the share of Chinese exports in the world total exports increased from

0.75% in 1978 to 3.0% in 1995. Growth rate of exports in 1996 for China was only 1.5%, resulting in a decline in its share of world trade. In 1997, however, fast growth of exports was restored, with an annual growth rate of 20.9%.

Since the beginning of reform, the size of China's market has expanded rapidly. In terms of total consumption (adjusted with GDP deflators, 1990=100), the average annual growth rate was 9.62% in 1979-1996. Total investment (adjusted) grew at an average annual growth rate of 10.54% in the same period (State Statistical Bureau 1996b, 1997b). This has been one of the most favourable conditions for stimulating the development of foreign trade. With the opening-up of the economy, China's imports have also greatly increased, from a share of 0.87% in world total imports in 1978 to 2.6% in 1995 and remained in 1996 (IMF 1995; WTO 1996, 1997). The above data imply that China has successfully enhanced its degree of integration into the world economy.

The significance of China's integration with the world economy has two main aspects. On the one hand, for China itself, the integration with the world economy extended the possibilities for obtaining necessary production and management resources to improve the allocative efficiency and productivity. More importantly, in the course of integration, many internationally common practices have been adopted and become vital forces in promoting the establishment of an open market-type economy in China.

China has benefited from the opening of her economy to the outside world. Besides obtaining foreign technology, equipment and production materials that may improve China's industrial capacity, the increase of trade-related investment from the outside world and various economic transactions with foreign countries has also provided China with an impulse to accelerate the economic growth. The participation of foreign investment in the Chinese economy, together with China's efforts in developing foreign trade and opening up its markets, accelerated China's integration with the world economy and promoted China as an increasingly important part of the global economic system.

Introducing the market competition mechanism into its previously centrally-controlled economy is also a goal of China's open policy. With the gradual reforms, especially since the late 1980s when China confirmed that its target was to establish a market economy, the increasing role of the competitive mechanism in the Chinese economy has pushed

enterprises to improve their efficiency. Traditionally, China's exports relied highly on low-efficient primary and labour-intensive products. Even in the post-reform period the rapid growth of exports was still mainly of these kinds of products, although the proportion of manufactured goods was greatly increased. In recent years, however, China has begun to transform its export pattern, from encouraging expansion in size to concentrating on growth in (both allocative and productive) efficiency, to improve the competitiveness in both domestic and foreign markets. The change in the trade growth pattern means that China has to pay more attention to technological improvement in export production. Meanwhile, as China's participation in the world markets became deeper and deeper, the domestic demand for liberalising foreign trade and the external pressures for conforming China's trade practice in accordance with international principles emerged as China's trade reform strategy. A result of China's trade policy liberalisation was that the functioning of the market mechanism in China became wider and deeper. In turn, competition was tightened and efficiency, again, was improved.

For the rest of the world, on the other hand, several impacts can be noted. First, the growth of the Chinese economy and the increasing openness of the economy provided, and will continue to provide, other countries with a huge market, injecting vital energy into the world economy. Second, the rise of China means that an increasingly strong competitor has emerged in world markets, prompting necessary trade policy adjustment for other countries. Third, China's participation in the world economy may have significant influence in the development of the world trade system and international economic order.

China's involvement in international competition has generated a positive effect in stimulating the adjustment of the international division of labour. The growth of China's competitiveness has also become a stimulation that encouraged further adjustment and innovation in other countries to improve their competitiveness. Many labour-intensive enterprises have been transplanted from developed countries and the NIEs to China since the end of the 1970s. Developed countries and the NIEs have had a good opportunity to upgrade their production and trade structures while China itself also benefited from introducing relatively advanced technology from the outside world and thus enhancing its capacity for industrial production. In this sense, China's growing competitiveness is a positive force promoting the development of the world economy, given that many countries have to take counter measures to improve their competitiveness.

Undoubtedly, an open and growing China market will benefit all China's trading partners. It is why most industrial and developing economies around the world are now interested in accessing China's market. The growing economic interdependence between China and the outside world, in turn, requires China to carry out further trade policy reforms. China's shift of trade reform from institutional adjustment to trade policy liberalisation since the 1990s demonstrated that China has had a more positive attitude towards the integration of its economy into the world economic system.

## **7.2 CHINA AND THE GATT/WTO**

For a deeper involvement in international trade, China made a great effort to develop its trade relations with other countries and the linkages with international economic organisations. The most important, and the most difficult, was its re-entry to GATT (now managed by the WTO) which sets and enforces the main rules of international trade.

### **7.2.1 China's Application to Rejoin GATT**

China was one of the 23 initial Contracting Parties which signed the Protocol of Provisional Application (PPA) on 21 April 1948. On 6 March 1950, the Nationalist government of China informed the General Secretary of the United Nations that China was withdrawing from the GATT. After China had restored all its rights at the UN, China was granted observer status in the GATT in 1982. On 10 July 1986, China made its official application for the resumption of its GATT Contracting Party status. In February 1987, the Chinese government presented a memorandum on its foreign trade to GATT. In the following month, GATT established a China Working Group to deal with the issue of restoring China's status in GATT. Since then, China's trade reform has drawn unexpectedly great attention from the main economies in the world.

Since March 1987 until the end of the Uruguay Round in December 1994, the China Working Group met some 19 times to discuss the issue of China's re-entry to GATT. In the first seven years after China's application, the China Working Group concentrated on examining China's foreign trade system. In the second half of 1992, the negotiations on China's re-entry turned to a discussion of the Protocol of Accession, and the negotiations on tariff reduction were conducted with some Contracting Parties on a bilateral basis. By October 1994, nearly 25 countries and the EU had negotiated with China but the talks with

the US made little progress (Walker and Wolf 1994). This situation lasted until the end of the year. China failed to re-enter the GATT before the establishment of the World Trade Organisation (WTO) and consequently could not become a founding member of the WTO.

Soon after the failure of China's entry to GATT/WTO at the end of 1994, during 9-19 May 1995, an informal negotiation about China's accession to GATT/WTO was held in Geneva, which signalled that the process of China's entry to the WTO was resumed. Since then, a series of formal and informal negotiations have been held. In July 1995, the WTO accepted China as an observer to the organisation. In 1997, three meetings of WTO China Working Group were held, in March, May and August. Until now (June 1998), 12 years after its submission of application, China is still not a member of the WTO.

Regardless of the differences in China's process of liberalisation compared to other countries, it is fact that China has kept moving toward trade liberalisation. In March 1997, China announced that it would eliminate a requirement that imports and exports be handled by state-approved enterprises. Two months later, in May, China announced that it would adhere to the WTO principle of non-discrimination (USITC 1997). In August 1997, China presented its new offer on market access which included the abandonment of export subsidies to agricultural products, a renewed timetable for the elimination of non-tariff barriers in a shorter period, and a further reduction of tariffs (*Wen Wei Po* 5/8/1997). These offers demonstrated China's commitment to conforming with the international trade practices. Once China has fulfilled its promises, its foreign trade system will have been liberalised significantly.

### **7.2.2 The Political Economy of China's GATT/WTO Accession**

In the contemporary world economy, countries become tightly interrelated and mutually complementary. Now all countries promote international economic co-operation and exchanges. For each individual country, there is a need to integrate its economy within the international community. The impetus for the resumption of China's GATT status derives from the need to develop elements of outward-oriented strategy. GATT (as part of the WTO since 31 December 1994) has become the most important body regulating international trade. Trade between GATT Contracting Parties covers more than 90% of total world trade. China, whilst still not a member of GATT/WTO, carries out nearly 90% of its foreign trade with GATT Contracting Parties.

### ***Something Benefiting All Sides***

For an economy like China in the course of economic opening-up, the importance of the GATT/WTO status can be easily understood. By participating in GATT/WTO as a developing country, China would receive all the benefits of GATT/WTO membership while it undertakes relatively smaller obligations. Of those benefits the main ones are:

First, as a member of the GATT/WTO, China could legally participate in the construction of the international trade regime and would have a voice in negotiating the rules of the world trade. China's position in the world trading system could be much enhanced and the external environment for China's economic development would be improved.

Second, China can enjoy the benefits of multilateral Most Favoured Nation (MFN) treatment, instead of the present bilateral MFN with some individual countries. The multilateral MFN is stable, has a wide-ranging coverage and is unlimited in time. Furthermore, a GATT/WTO member can also enjoy the most preferred tariff system that is helpful for the expansion of foreign trade. Therefore, becoming a member of GATT/WTO would help China to increase its exports and widen its external markets.

Third, China can avoid most unfair trade treatments encountered in the present situation. In the multilateral trading system under the rules of GATT/WTO, China's trade benefits and economic interests can be protected much better. For example, if China as a full GATT/WTO member was not given MFN treatment by the United States, it could claim a violation of GATT rules. Membership of GATT/WTO would also provide China with an easier access to other developed country markets.

Fourth, joining the GATT/WTO means domestic industries must compete with foreign companies. It thus pushes domestic enterprises to improve their technological ability, to improve operation management and to increase economic efficiency. It can help to enhance the competitiveness of Chinese products.

Fifth, the root of the GATT/WTO is a market economy. To integrate the economy with the international society and to follow the principles of GATT/WTO, China needs to persist in its reform and open-door policy. With the openness of the economy and the introduction

of international competition, enterprises have to transfer their operation mechanism from administrative supervision to a mode of "self-development". It will accelerate the transition of China's economic system from the planned or semi-planned economy to a "socialist market economy". In this sense, membership in the GATT/WTO is an accelerator speeding up the transformation of the Chinese economy.

On the other hand, China's application for its GATT/WTO membership has, and will have, a momentous influence on the development of world trade. China's application for GATT/WTO entry is a measure to integrate its economy with the rest of the world. Certainly, the opening-up of the Chinese economy may provide many opportunities to other countries for their economic and trade development. Moreover, China's entry would enable GATT/WTO to be a truly world-wide trade organisation. Global trade liberalisation could be effectively extended to a wider range. As a member, China would further open its huge market to all other members, according to the Most Favoured Nation (MFN) rule of GATT/WTO. As one researcher indicated, "a country of China's resource and potential, committed to maximising the productivity of its own economy through reliance on market forces and participation in the world economy on the basis of its own evolving comparative advantage, could boost world trade and world economic growth as well as its own" (Hartland-Thunburg 1990). Given this, almost all main countries in the world have recognised the importance of China's participation in the world economy. For example, the USTR stated that China is the world's fastest growing major economy and, by early in the next century, may have the world's largest economy. "For the United States, it is certainly true that China offers unmatched 'potential'" (Kantor 1996). Bilateral trade played a very important role in China-US relationship. The EU, Japan, Australia and many developing countries also appreciated the market opportunities relating to China's economic opening-up and GATT/WTO status.

### ***Arguments on China's Re-entry into GATT/WTO***

Since China plays such an important and growing role in world trade, there should be a common foundation on all sides with regard to China's re-entry. However, due to the differential criteria for China's entry held by China itself and a few WTO members, negotiations on China's status in GATT/WTO have not yet reached a successful conclusion.



Worries about China's participation have been raised, whilst the importance of China's application is recognised. Concerns mainly centre on China's trade regime and trade policy. China has claimed that, after more than a decade reform, its economic and trade regime has basically been consistent with the principles outlined in the GATT and the conditions for its re-entry have been fulfilled (*People's Daily* 23/12/1994; Wu Yi 1995). But some GATT/WTO members, led by the United States, insist that China still has much to do before becoming a member of GATT/WTO (*Trade News* 1/9/1994, 2/11/1994, 8/11/1995, 9/8/1996).

When it presented its application to GATT, China claimed three main principles which reflect its attitude towards the resumption of GATT status. First, China is to re-enter GATT instead of joining the institution as a new Contracting Party. That means China's intention is to resume its signatory status of GATT. Second, China will pay for its "ticket of accession" mainly by reducing tariffs rather than committing import obligations, since China is becoming a market-oriented economy. Third, China will rejoin GATT as a developing country (Zhou Hanmin 1995). These principles, however, together with relevant economic and trade policies, have encountered serious challenges from some Contracting Parties, particularly the United States.

The re-entry issue has become outdated in the context of the WTO, established as a new organisation managing the GATT and other international trade agreements. The only approach for China's participation in this organisation is to join it. The "ticket of accession" is a flexible concept which depends highly on China's negotiations with WTO members. In fact, China has to commit herself to more obligations in trade liberalisation than simply reducing tariffs, given firstly that reduction of non-tariff measures has been the focus of trade policy in and out the WTO and secondly that China's trade system needs to be liberalised. As parts of trade liberalisation, China has taken many measures to reduce its tariffs and non-tariff restrictions. China has also signed the Uruguay Round final documents that cover a wider range of trade barrier elimination. China's cost for entering the WTO has gone far beyond tariff reduction.

The crucial issue once being controvertible is whether China should be counted as a developing country or not. There are several reasons for Chinese to hold out for developing country status. First, the pattern of development is an important factor in judging the economic situation of a country. Once a country has completed its industrialisation, it can

be regarded as a developed country. China is just at its transition from an agricultural-industrial society to an industrialising society. Furthermore, the process of industrialisation takes a considerable time to complete. In this case, China can be regarded as a developing country. Second, a country's real level of development may be measured by some aggregate economic indicators. The most important one is GNP (or GDP) per capita which shows the real level of average income in each country. China's GNP per capita in 1992 was estimated at US\$470 (World Bank 1994b). If China's GNP per capita of US\$ 470 was admitted, China would be accepted to the WTO as a developing country. Even giving consideration to the estimates based on the PPP method, as discussed in Chapter 6, China's GNP per capita is still at a relatively low level. In the *World Development Report 1994*, for example, the PPP estimate of China's 1992 GNP per capita was US\$1,910. Among 121 economies in the table, China ranked 92nd, lower than Nicaragua, Pakistan, Sri Lanka, Philippines and many other typical developing countries.<sup>[1]</sup> Therefore, it is not appropriate to identify China as a developed country even according to the PPP estimates. Moreover, since the result of the PPP method "would naturally be higher than the exchange rate-based estimates" (World Bank 1995), the criteria for defining developing country status should also be readjusted as well. If a country such as China with a GNP per capita of US\$1,910 in 1992 can be identified as a developed country, the logically extended conclusion would be that most countries in the world are developed countries. The concept of developing country will become insignificant or even meaningless in development economics.

If GNP per capita does not represent the level of economic development in a country, then what criteria can be used? The United State argued that China should be treated as a developed country, according to the following arguments: firstly, China's aggregate economic indicators rank in the top range in the world and China's foreign trade has rapidly grown over past years, generating a huge trade surplus with the United States; secondly, no developing country has a modernised capital city like Beijing; thirdly, no developing country except China can launch satellites for developed countries; and finally, no developing country had such a good performance in applying to be host for the 2000 Olympic Games (*Economist* 6/8/1994; Zhou Hanmin 1995). Considering these criteria, some questions have been raised in measuring China's development situation. One is that the total economic indicators have a tight link with the size of the economy. In the case of China, although China's total GNP in 1994 ranked the second in the world and China's exports and foreign exchange reserves ranked 11th and 5th in the world respectively, this by

no means shows that China has reached the place of a developed nation. The other is that China's rapid economic and trade growth and good performance in certain aspects only showed China's potential and advantage in certain industries and areas. High growth rates did not mean that a high level of development has been reached, especially when the growth was from a low base. For example, by 1994, although China's exports grew at a high growth rate over time, it only accounts for less than 3% of the world total exports, compared with the United States' share of 12.3%. If the population factor was considered, the average export per head in China was only about US\$100 in 1994 while the figure for the United States was more than US\$2,500. China is becoming stronger but has not yet been strong enough to be regarded as a developed country.

Behind these arguments, the real concern is the trade benefit potential. China seemed eager to enjoy all preferential treatment for developing countries but intended to minimise its liberalisation commitments. Also, China wanted to pursue gradual reform of its trade regime and trade policies to keep pace with its overall economic transition. Less and slower removal of trade protection was thought to be helpful in avoiding major upheavals and market disruptions in reform process and maintaining rapid economic growth. More importantly, if China accepted the condition that it is counted as a developed country, it would lose the eligibility to enjoy all existing preferential treatments as a developing country including financial supports from the World Bank, IMF, and general system of preferences (GSP) treatment from all developed countries except the USA. In addition, as a developed country, China would have to accept obligations like other developed countries. These include accepting the international payments balance clause, eliminating all NTBs and offering preferential treatment to developing members. The consequences for China would be that China's rights and obligations in the WTO would be severely unbalance in terms of its current economic conditions and the level of development. China's domestic industries would have to compete with mature western industries. China's economic development would face a more difficult environment and the pace of growth would most probably have to slow down. Being aware of these factors, China unequivocally stands by her application to join the WTO as a developing country.

On the opposite side, the United States, and a few other developed members, have aimed to use GATT/WTO as a tool to open China's huge markets. The United States, for example, has been pressing China to increase its offer for GATT/WTO accession. All the

conditions the United States has asked for are related to the hypothesis that China should be treated as a developed country. If China were successfully counted as a developed country, it could no longer take the advantages of preferential treatment from the world trading system enjoyed by other developing countries. The development of her growth potential would be greatly weakened. The "China threat" could be postponed and even disappear. Furthermore, by giving a developed country hat to China, all other developing countries also could be "upgraded" to developed countries. The real distance between developed and developing countries may be fixed at present levels and extended into the future, while the nominal difference between the countries will be eliminated by reducing the application of the concept of developing country. The United States could have "fair" competition with those new "developed" countries based on its economic superpower and so further her own interests.

Obviously, developed economy status for China in the WTO was a strategy to ensure substantial economic liberalisation in China. As some indicated, whether China enters the WTO as a developed economy or as a developing country is not of the extreme importance. The imminent problem is to reach an agreement on a short timetable for China's trade liberalisation (Garnaut 1995). "The United States should moderate its demands for reform as a precondition for China's membership in the WTO. In exchange the United States should expect China to agree to a schedule that would gradually bring the country into compliance with WTO standards" (Lardy 1996). What concerns the WTO members is the possibility of maintaining and/or increasing access to China's rapidly growing domestic markets, as well as avoiding the possible market disruption in developed economies caused by China's expansion of manufacturing exports. The aim of identifying China as a developed country was to ensure that China achieved a liberalised trade system. However, if China could commits herself to building a liberalised trade system, it would be not necessary to force China to accept developed country status. Following long-lasting argument, the US finally accepted in principle China's request to join the WTO as a developing country (*Trade News* 25/5/1995). US officials, however, insisted that China must go further in its commitments to reduce tariffs, open markets, eliminate exclusive trading rights and liberalise investment (*Trade News* 9/8/1996). In other words, the acceleration of trade liberalisation is a core requirement for China to enter the WTO.

Different opinions held by China and other WTO members were also concretely shown in the implications for trade policies. The major differentials regarding trade policy reform in China are shown in Table 7.3.

**Table 7.3 Discrepancies in China's Trade Policy Reform (up to 1997)**

	WTO members' demand	China's opinion
Trade regime transparency	All trade laws and regulations, and trade policy measures such as quotas should be made public.	At least at present, not all trade measures should be published due to commercial confidentiality.
Trading rights	Foreign enterprises should be allowed into the trading sector. State monopoly and canalisation need to be removed.	Trading rights will be granted to domestic enterprises and foreign-funded enterprises with designed scope of business. A registration system for foreign trade has been promised.
Foreign exchange system	All exchange controls need to be removed and the domestic currency be fully convertible as early as entering the WTO.	Certain exchange controls will remain. The complete convertibility of the <i>Renminbi</i> is subject to the official timetable.
Tariffs	Overall tariff level should be reduced to less than 10%. China needs to participate in the Uruguay Round zero-for-zero tariff reductions and tariff harmonisation agreed by the Quad economies (The US, Canada, the EU and Japan).	Tariffs will be lowered to the average level of developing countries. Like some other developing countries, China does not have to join the zero-for-zero tariff reductions and the tariff harmonisation since they have been proposed for developed economies.
Non-tariff barriers	China must eliminate major non-tariff barriers in a short time.	China intends to retain some non-tariff measures (quotas, licences), particularly in some infant or special industries (automobile, agriculture).
Safeguards	China needs to accept an "alternative protection clause" as a condition for its GATT/WTO accession before it has completed reforms on price and foreign exchange systems. China must agree to be evaluated on trade policy every half a year.	China opposes this special safeguard mechanism on the grounds that it is regarded as a discriminatory measure. As a developing member of the WTO, trade policy should be evaluated every four years in accordance with the WTO's rule of "trade policy evaluation mechanism".
Multilateral trade agreement	China must sign multi-lateral trade commitments on individual commodities reached at the Tokyo Round as a precondition of its GATT/WTO accession.	According to the Agreement of Uruguay Round, the member of the WTO has to accept all exist multilateral trade agreements but join any multi-lateral trade commitment on any individual commodity on a voluntary mode.
Trade in services	China should open a wider range of service sectors, including finance, insurance, telecommunication, retail and wholesale, and audio-visual industry.	China insists that the opening up of the Chinese service sectors should match China's overall level of development, according to the General Agreement on Trade in Services (GATS) conducted in the Uruguay Round that the opening up of the service sectors in developing countries will be determined by individual countries according to their policy goals and economic development situation ( <i>GATS Article XIX</i> ).
Trade-related investment	China should eliminate investment restrictions such as local ingredient, export proportion, self-balance of foreign exchange earning and expending, and foreign exchange controls, and provide national treatment to foreign investors.	China has provided foreign investors with better treatment than domestic enterprises. Foreign-funded enterprises will be gradually granted national treatment.

Source: Author, based on *Economist* 14/5/1994, 6/8/1994; *Financial Times* 6/10/1994, 5/12/1994, 22/12/1994; Zhong Dajun (1995); Zhang Li (1995); Ma Jianchun (1995); Zhou Hanmin (1995); Tang Haiyan (1995); Xue Yongjiu (1995); Li Zhongzhou (1996a, 1996b); Wu Jiahuang (1996); Yang Yongzheng (1996); Lardy (1996); Kim (1996); Wang Zixian (1997); Yao Shufeng (1997); Li Yushi (1997); USITC (1997).

Most of WTO members' demands are reasonable on the grounds of trade liberalisation. The problem remains as to what extent China could, and should, reach them. This also relates to China's prospective status in the WTO and to China's capacity to commit itself to a rapid pace of trade policy reform. After its application to rejoin GATT, the foreign trade system reforms were accelerated in China. Trade policies have been changed significantly to conform with GATT/WTO rules. Despite the various difficulties in trade reforms, China has made great efforts to accelerate the pace of trade liberalisation in recent years, in order to transform China's trade regime in line with international trade practice.

On the other hand, however, it is also fair to say that China's trade regime has not yet become a liberalised one. Tariff rates are still high. Various non-tariff measures continue to be used for regulating exports and imports. The market mechanism has not completely been established and all trade-related aspects are heavily influenced by government supervisions (Wang Zixian 1997b). Despite China's repeated claims that its economic and trade systems have been basically consistent with the principles outlined in the GATT/WTO (Wu Yi 1994, 1995; *Beijing Review* 15-21/7/1996), the fact is that progress in trade policy reform has been slow and not enough to cover the gap between China's offer and the demand of some WTO members. US officials insisted that China must go further in commitments to reduce tariffs, open up markets, eliminate exclusive trading rights and liberalise investment. The US International Trade Commission (USITC) also pointed out that China's WTO application progressed slowly (USITC 1997). China has argued that these measures could increase unemployment and domestic social instability (*Trade News* 9/8/1996). China also claims that it will not compromise with any country on its main principles for the WTO entry which protect China's national interests in the world trade system.

Given the different criteria held by China itself and a few WTO members, it seems the arguments on China's entry will continue and negotiation on these issues will be a sophisticated and difficult task. Nevertheless, it is clear that China has to further its trade reform, for both domestic economic transition and its WTO entry. However, China's integration into the world economy is not a unilateral matter. China's trade reform process has been, and will continue to be, affected by various attitudes and issues of other countries. External factors, either encouragement or pressure, have effectively promoted China to accelerate its trade policy reform. In dealing with the trade relations with other countries,

China made its effort in trade policy adjustment to conform with international rules, as well as solving the specified trade issues with different countries.

### 7.3 CHINA AND THE UNITED STATES

#### 7.3.1 Bilateral Trade

Given the position of the United States in the world economy, the China-US economic relationship has been an indisputable factor influencing the process of China's integration into the international community. After the normalising of bilateral diplomatic relations between China and the USA in 1979, economic co-operation and two-way trade developed rapidly and has brought both countries numerous economic benefits.

**Table 7.4 China-US Bilateral Trade Statistics** (US\$ billion)

Year	By China Customs				By US Department of Commerce			
	Total	Exports to US	Imports from US	Trade balance	Total	Exports to China	Imports from China	Trade balance
1978	0.991	0.271	0.721	-0.45	1.178	0.822	0.356	0.47
1980	4.787	0.962	3.824	-2.86	4.918	3.754	1.164	2.59
1985	7.024	2.652	4.373	-1.72	7.713	3.851	3.861	-0.01
1990	11.770	5.190	6.580	-1.39	20.031	4.807	15.224	-10.42
1991	14.202	6.194	8.008	-1.81	25.262	6.287	18.976	-12.69
1992	17.490	8.590	8.900	-0.31	33.200	7.470	25.730	-18.26
1993	27.652	16.964	10.688	6.28	40.303	8.767	31.535	-22.77
1994	35.430	21.460	13.970	7.49	48.070	9.288	38.782	-29.49
1995	40.830	24.710	16.120	8.59	57.310	11.750	45.560	-33.81
1996	42.840	26.690	16.160	10.53	63.460	11.970	51.490	-39.52

Source: Quoted and compiled from Ma Xiaoye and Zheng Handa (1996), Wu Yi (1996) and The Press Office of the State Council, P. R. China (1997).

According to Chinese statistics, two-way trade has achieved an annual average growth rate of 20%, increasing from US\$2.5 billion in 1979 to US\$42.84 billion in 1996. At present, bilateral trade accounts for 14.5% of China's gross trade and 4.3% of that of the United States. The United States is China's third largest trade partner, and the United States has identified China as the most important emerging market, offering the greatest potential (Wu Yi 1996). However, as shown in Table 7.4, the two different sets of data tell very different stories for each country. The United States argues that it has suffered a tremendous deficit in its trade with China. While China agrees that it has in fact enjoyed a trade surplus with the United States, it considers the trade surplus to be a much smaller one than claimed by the US.

The discrepancy in calculating trade balances between the United States and China is, by and large, related to the different statistical criteria used by each. Based on the statistics

kept by the United States, China was next only to Japan in terms of its surplus with the United States, given the trade surplus in bilateral trade appeared for the first time in 1983 (\$0.3 billion) and increased to \$39.52 billion in 1996. Based on China's statistics, on the other hand, China has only enjoyed a trade surplus since 1993 (\$6.28 billion in the year) and the amount of surplus in 1996 was only \$10.53 billion.

The explanation for the difference in the trade balances estimated by the two countries significantly differ. The United States insists that its trade statistics have been compiled according to international guidelines (Wu Yi 1996). Some Chinese authors have pointed out that such "international guidelines" are a complete US-version of determination which depends on United States "Rules of Origin". The US determination of the place of origin is generally based on the customs declaration forms filled in by US importers or customs brokers. Many products exported by third places such as Hong Kong and Singapore but which were previously processed in mainland China are labelled as originating in China, simply due to the requirement in the declaration form to mention the last stop of the goods. These goods, transhipped from third places, were treated as Chinese exports to the US (Ma Xiaoye and Zheng Handa 1996). By adjusting the transshipment and mark-up factor, it is thought that the United States has overstated its trade deficit with China by \$13 billion, or 60% of the actual amount in 1995 (Wu Yi 1996). Regarding the 1996 data, China claims that the United States has overstated its trade deficit with China by about US\$16 billion (The Press Office of the State Council of China 1997).

The US statistical approach has also been criticised in the United States. In the words of an American scholar:

"U.S. data on bilateral trade with China are seriously flawed. Although this year U.S. firms will sell about \$6 billion to China via Hong Kong middlemen, the Department of Commerce insists on calling these transactions sales to Hong Kong. But the department counts as imports from China all Chinese products reexported from Hong Kong to the United States. Unfortunately, the department also includes the value added by Hong Kong companies as part of the total value of imports from China. In the process U.S. officials will overstate imports from China this year by \$7 billion. The upshot is that this year the real U.S. trade imbalance with China is likely to total about \$25 billion, one-third less than a projection of \$38 billion based on U.S. government data. That would represent an increase of about 10 percent, the slowest rate of increase since the real bilateral deficit first emerged in the late 1980s, and one-third less than an anticipated 1996 deficit with Japan of \$40 billion. In short, the U.S. deficit with China is not increasing rapidly." (Lardy 1996)



It is not surprising that different countries have their own rules guiding statistical practices. The real risk of discrepancies in trade balance between countries, however, is that the large trade deficit may lead the related country to seek protectionist trade policy or put pressure onto the counterpart. In the case of China-US trade, the US's response was more sensitive than China's. Some people in the United States have argued that since mid-1980s US bilateral trade deficits were in part caused by China's import policies restricting US export capacities (USTR 1994). Even in the situation of 1995 when US exports to China grew at a more rapid rate, 27%, than US imports from China, which grew 17%, China was still regarded as "one of the world's most closed markets for goods and services". In the USTR's view, US exports to China "have been artificially restricted by unfair and discriminatory trade practice". "China's burgeoning economy should be absorbing more and more US exports, and not be protected by outmoded barriers" (Kantor 1996). Such an assessment has naturally led to the conclusion that the USTR was required to press China to liberalise its trade policies.

### **7.3.2 The Role of the "US Factor" in China's Trade Reform**

The dispute on the trade balance was only one of a series of trade disputes between China and the United States. In fact, trade friction and relevant disputes between the two countries have erupted one after another since the mid-1980s. The range of these disputes covered textile trade, intellectual property right (IPR) protection, market access, the most-favoured-nation (MFN) treatment, the trade deficit and China's GATT re-entry/WTO accession. These trade disputes blocked the development of bilateral trade and, naturally, had a significant influence on China's opening process.

#### ***"Negotiated" Trade Policy Reforms***

Trade policy had once been regarded as a matter of domestic concern and, although usually with a delay, adapted by the government to the changing circumstance. The motives for trade policy reform therefore are usually derived from the changes of a country's trade and development strategy. On the other hand, however, given the features of foreign trade and international economic linkages, any change in a country's trade policy will certainly have effects on other economies. In this sense, trade policy reform could not be a pure domestic matter of the reforming country. This leads reasonably to a situation in which some major trade partners and international organisations are involved in the process of trade policy reform in the reforming country. Very often, and understandably, the

involvement of the external factors is to direct the changes of trade policies in the reforming country, regardless of whether the reforming country is co-operative or reluctant. If the gaps between the reforming country and the external forces exists, the actual consequence may be to carry out a “negotiated” trade policy reform. That is, the targets, the pace or timing, and even the measures of trade policy reform are to be determined in the process of bargaining between the reforming country and the external forces.

Interestingly, China’s trade policy reform has experienced the above described change from unilateral trade policy reform to a “negotiated” one. Before the mid-1980s, China’s trade policy reforms were basically self-motivated. All reform measures like decentralisation and the resulting relaxation of trade restrictions were very much appreciated by the western world. However, from the late 1980s, especially after China made her application for GATT re-entry, external forces became increasingly involved in China’s trade policy reform. Among them, the “US factor” has effectively influenced the process of trade liberalisation in China.

There were two approaches in which the “US factor” affected China’s trade policy reform. In one way, we just mentioned in the early part of this chapter, the United States as a leading GATT/WTO member played a determinative role in dealing with the issue of China’s GATT/WTO accession. In the other way, the United States caught every chance in dealing the bilateral trade relations with China to push it toward trade liberalisation. Such a function of the “US factor” was fully reflected in the trade disputes between China and the United States. The main purposes for both the United States and China, behind the disputes and resulting talks, was to push the counterpart’s markets open whilst minimising any possible disruption of domestic markets. In the disputes, however, the United States seemed stronger and placed continuous pressure on China, demanding a fast trade liberalisation. Negotiations on market access and on intellectual property rights are clear examples.

### ***How Important Is the “US Factor”?***

The importance of the “US factor” in China’s trade policy reform can be understood on the following grounds. First, the United States captured a special position in the world economy. Because of its super economic power and market capacity, the United States plays one of the determining roles in international economic affairs. While integrating its economy with the rest of the world, China has to face the fact that the US factor operates

within almost every area of the world economy and most major international organisations. Thus the US factor had had, and will continue to have, a strong influence on China's opening-up process. China's experience in applying for GATT/WTO status bears witness to this.

Second, the United States is one of the most important trade partners to China. In 1996, trade with the USA accounted for almost one fifth of China's total trade. Discrepancies on trade policy issues between the two countries, once developed to a certain degree, could lead to a setback of the growing trade relations. This would be an extremely serious obstacle to China's opening-up and growth process. China's exports have been very much concentrated on a few foreign markets including the USA. Meanwhile, a large part of China's imports of production facility have been from the USA. For these reasons, China indeed needed to maintain the trade relations with the USA and give sufficient attention to USA's demand on trade policy reform for China.

Third, and more important, China's trade policy reform has been directed towards trade liberalisation. Significantly, regardless of the motive that led the USA to put pressure on China's trade policy reform, the USA's demands are basically on the line of trade liberalisation. Here the connection point exists. On this basis, the "US factor" has functioned, with great influence, to promote China's trade policy reform. The USA's tough stand on the issues of China's accession to GATT/WTO and of the bilateral trade relations has, in fact, forced China to accelerate the pace of trade policy reform.

However, it is equally important that one should not overestimate the role of the US factor in China's trade reform. China has shown that it will insist on its own principles in the key trade issues. Many major trade reforms were initially launched by China itself in accordance with the development of the national economy, and controlled by the government. The advantage of this situation was that the government could keep the pace of trade reform with the overall economic transition, and ensure that the trade policy reform continues to realise its national economic targets and to benefit growth. The disadvantage may be that the trade reform could be slow or even stagnate, given the difficulties in reforming the state-owned economy.

Further, it is also necessary to note that not every kind of USA demand was reasonable. As analysed earlier, particularly regarding China's accession to the WTO, some US demands were too excessive for China. Of course, China's integration with the international economy is not a unilateral or internal affair, dependent solely on its own willingness. It is also not surprising that a few industrial countries may try to interfere or direct the process of China's trade policy reform. The US factor is just functioning on such a basis. A conspicuous intention of US policy towards China seems to be that the United States wants to affect the direction of China's trade reform. This is demonstrated by the US requirements on various trade issues. While the United States made requirements on China, US-interest-centred objectives became the dominating force throughout the bilateral trade talks between China and the United States. The issue is not that the US took advantage of China's integration with the international economy to pursue its specific objectives but that the US demands were, as Chinese officials and scholars pointed out, excessive and impracticable for China (Zhou Hanmin 1995; Tang Haiyan 1995; Xue Yongjiu 1995; Li Zhongzhou 1996a, 1996b). Some western scholars also criticised the excessive demands on China's entry (Lardy 1996; Wall 1996).

In addition, the functioning of the US factor contains US political and strategic considerations. The making of US China policy cannot exclude the influence of political relations between the two countries and the goals of US global strategy. By examining the historical changes of US trade policy towards China, Zhang Zhengyu (1995) pointed out that a political element can be seen to have been holding the leading position in the making that policy. China is one of the few socialist countries in the world still led by a Communist Party. After the end of the Cold War, China became the only counterbalance to the United States on political issues because there is a basic difference in the nature of the social systems in these two big countries. For its ideological target, the United States has employed all its means, of which trade policy is the most powerful tool, to try to direct China into the capitalist world. Therefore it is not surprising that the United States has imposed a series of political conditions on its trade policy toward China. At present, the United States is the only developed country that has not granted GSP treatment to China, because US laws have special prescriptions for the implementation of GSP to socialist countries. Linking human rights with China's MFN status was another example, which showed the political colour of US trade policy. For the United States, as Chinese leaders

and scholars have argued, China's re-entry to GATT has been really treated as a political question rather than an economic issue (*Beijing Review* 15-21/7/1996; Tang Haiyan 1995).

It seems that both China and the USA face their own dilemma. For the USA, a growing Chinese economy offers a great market opportunity. China's integration with and involvement in the world economy could further expand such an opportunity in which the USA may have greater interest. On the other hand, it is the "rise of China" may increase the risk of the "China threat" to USA's super power position, especially in the absence of a complete market system and a liberalised trade regime. US trade policy toward China therefore aimed to ensure the real progress of trade liberalisation. For China, integration with and involvement in the world economy enables it to create a better environment for its economic development but at the expense of trade policy reform. A few years ago, China was eager to join GATT/WTO but reluctant to carry out fast trade policy reform. Nevertheless, in the view of long-run development, trade liberalisation has been the goal of China's trade policy reform. The "negotiated" trade policy reform at present stage made some progress in trade liberalisation in China, less than the USA expected but fast than China prepared.

#### 7.4 CHINA AND THE EU

China established formal diplomatic relations with the EU (EC) in 1973. A trade agreement was signed in April 1978, taking effect in June of that year, which called for the promotion of exchange in the field of economics, trade, and industry. In May 1985, a new trade and economic co-operation agreement (*EEC-China Trade and Economic Co-operation Agreement*) was signed and trade relations between the two sides were strengthened. Over the past two decades, although there was a setback due to the event of June 1989, economic and trade relation between China and EU countries has improved.

**Table 7.5 China's Trade with the EU** (US\$ billions)

	1980	1985	1990	1991	1992	1993	1994	1995	1996
Exports to the EU	2.314	2.283	6.275	7.127	8.004	12.258	15.418	19.122	19.868
Imports from the EU	2.744	6.151	9.147	9.297	10.863	15.739	18.604	21.257	19.883

Source: IMF, *Direction of Trade Statistic Yearbook*, 1985, p. 138; 1988, p. 138; 1997, pp. 159.

Compared with the United States, the EU held a more moderate policy towards China. The EU countries have enjoyed economic stimulation generated by the fast economic growth of the East Asian economy. The sound growth of Asian economies increased

demand for imports which provided EU countries with the opportunity to resuscitate their economies. In the case of trade with China, according to IMF statistics, EU exports to China (i.e. China's imports from the EU) increased from US\$2.314 billion in 1980 to US\$19.868 billion in 1996. Even on the basis of EU statistics, EU exports to China also increased from 6.9 billion *ecu* in 1992 to 12.4 billion *ecu* in 1994, almost doubling in the three year period (Tanaka 1996). From the above data, it can be seen that a sharp increase of trade between China and the EU began in 1993. An important contributing factor was that in 1991 China made a foreign trade strategy decision to develop a pluralistic international market (Sheng Danyang 1994). That means, while expanding trade with traditional trade-partners, China would develop trade relations with other new and potential trade partners, and re-balance China's trade relations with all trade partners as well. Historically China's foreign markets were concentrated on Hong Kong, Japan and North America, although there were some trade linkages with EU countries. Compared with the trade with Hong Kong, Japan and the United States, China's trade with the EU is much smaller. The market multilateralisation strategy put China's trade relations with the EU in a more important position, given that its trade relations with the United States have experienced a certain amount of friction since the 1990s.

On the side of the EU, it also changed its policy from adhering to political issues to one based on the improvement of economic and trade relations. This resulted in a marked increase in exchanges and co-operations between the EU and China. In view of China's rapid growth, the European Commission drafted its strategy (*A Long-Term Policy for China-Europe Relations*, released on 5 July 1995 and then formally adopted on 3 October 1995) to build closer ties with China. This was the first time that the EU made an overall policy toward China, as an EU leader said (*People's Daily* 7/7/1995). The EU has noted that there have been dramatic changes in the Chinese economy and society since the full-scale promotion of reforms and the adoption of the open-door policy, and the EU also had an interest in ensuring that these trends are not to be reversed. Therefore, the EU had set its policies to support China's implementation of reform and the open-door policy. That is to encourage the completion of its transformation from a planned economy to a market economy, support China's involvement in the stabilisation of the international economy and China's membership in the WTO, and encourage EU companies to enter the Chinese market for developing economic and trade relations between the two sides and

strengthening the competitiveness of the EU's companies (*People's Daily* 7/7/1995; Tanaka 1996). Particularly, on the issue of China's WTO membership, the EU deems that China's entry into the WTO will bring great benefits to all parties. Given that China's economy is in the process of transition, the EU suggested that the WTO should adopt an approach of "transitional period" to deal with China's membership of the organisation. In EU's opinion, China could be first allowed to enter the WTO on condition of accepting the main principles of the organisation and then, in an agreed "transitional period", fulfil the relative obligations agreed by China and other WTO members (Wang He 1996).

Undeniably, there are still some discrepancies between China and the EU on some trade issues and these may affect the development of trade relations between them. For example, in 1970, the EC (now the EU) classified China as a non-market economy (Xiao Zhiyue 1993, p.11). By 1994, the EU still regarded China as a country of "state trade". This induced the EU to apply different policies to China. China's exports still meet with some NTBs in European markets. By the end of 1994, there were 54 catalogue products which had been subjected to anti-dumping investigations by the EU (European Department, MOFECT 1995). The increase in anti-dumping proceedings by the EU is a clear signal that the EU wishes to protect its domestic industry from low priced competition from China (Xiao Zhiyue 1993). Solution of these trade disputes requires a further adjustment of bilateral trade policies on both sides. What is clear is that there is a huge potential to improve trade relations between China and the EU, with respect to their market size, economic complementarity and, more importantly, the significance of expanding bilateral trade relations for the development of their own economies.

## **7.5 CHINA AND EAST ASIAN ECONOMIES**

Over the last two decades more, East Asian economies have achieved an astonishing growth. A vast literature has addressed the causes of this rapid growth in East Asia economies. The elements discussed cover a wide range of social and economic aspects. The success of East Asian economies has been attributed, in addition to the support of an appropriate international environment, to their stable macroeconomic conditions, high saving rates, accumulation of qualified human resource, well-functioning market mechanism, government intervention, and export-led strategies (World Bank 1993; Hughes 1995; Vaidya and Wang Xinmin 1995; Stiglitz 1996; Cheng Qizhen 1996).

Discussing the reasons for the achievements of Asian economies on a broad basis is beyond the aim of this study. However, it should be noted that growth in these economies has been on a background of rapid expansion in external trade. Promoting export production to increase exports has been a major impetus for the enhancement of productivity in these economies (Vaidya and Wang Xinmin 1995). The rapid growth of exports, especially the exports of manufactures, played an important role in the rapid overall economic growth of Asian economies (World Bank 1993). While noting the impact of Asian economic and trade growth on the world economy, the special significance of East Asian economies for China's economic development and trade policy reform is also noteworthy. As a major economy in the region, China contributed to, and benefited from, the fast growth of the Asian economy.

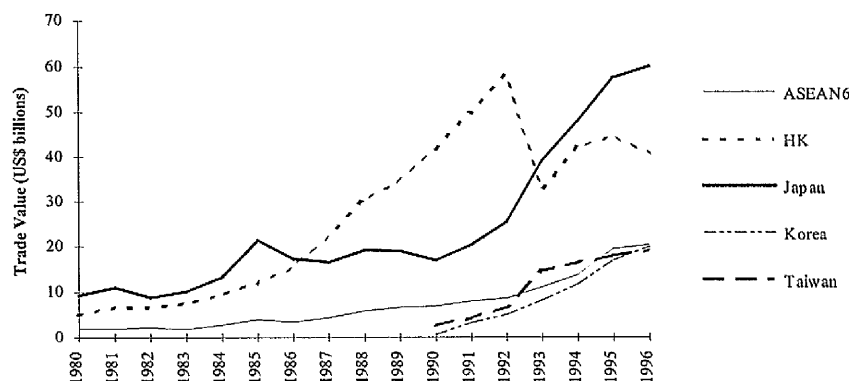
#### **7.5.1 The Rapid Growth of China's Foreign Trade with East Asian Economies**

With regard to the size and components of China's trade with East Asian economies, in particular with Japan and Hong Kong, it is more important than with many others countries. Several aspects show this unusual importance. First, as shown in Figure 7.1, China has important trade linkages with the other economies in East Asia. Trade with ten major East Asian economies (Japan, Hong Kong, Korea, Taiwan and six ASEAN economies) accounted for over a half of China's total trade (55.25% in 1996). Among them, both Hong Kong and Japan are among the first three of China's trade partners (The USA was the second in recent years except in 1995 when it was in the first place). Hong Kong has long been one of China's most important export destinations and import sources. The share of Hong Kong in China's total trade grew from 12.91% in 1980 to 29.42% in 1988. By the early 1990s, when China's external trade was affected by the event of June 1989, near half of China's exports (44.74% in 1991) and more than a quarter of imports (27.50% in 1991) were traded with Hong Kong's enterprises. In recent years, although the share of trade with Hong Kong has declined relatively (15.88% in 1995 and 14.05% in 1996) due partially to the development with more direct trade with other countries, its importance as China's major trade partner has remained. China-Japan bilateral trade has increased rapidly since the normalisation of the bilateral diplomatic relation between the two countries, from about US\$1 billion in 1972 to US\$10 billion in 1981 and US\$20 billion in 1991. Since the 1990s, China-Japan trade has been expanded in a high speed and reached US\$60 billion in 1996, accounting for one-fifth (20.72%) of China's total foreign trade. Japan is now China's largest trade partner and China stands in the second place on Japan's trade partner list.



Besides trading with Japan and Hong Kong, China's trade with other Asian economies has also increased rapidly. Trade with Korea and Taiwan, in particular, registered very high growth rates since the 1990s.

Figure 7.1 China's Trade with Ten Major East Asian Economies



Note: ASEAN6 includes Singapore, Malaysia, Indonesia, Thailand, Philippines and Viet Nam.

Source: IMF, *Direction of Trade Statistics Yearbook*, various issues.

Second, the fast growing East Asian economies have been important sources of capital inflows to China. Since 1978 through the end of 1995, China had approved 259,379 foreign-funded projects, involving a total negotiated foreign investment of US\$395.12 billion. The total amount of foreign investment actually used had reached US\$135.08 billion (Li Bin 1996). Most of these foreign investments came from Asian economies, especially from Hong Kong, Taiwan and Japan. For example, in 1979-1991, the percentage of foreign investment from Hong Kong and Macao, Taiwan, Japan, Singapore, and Thailand were 62.2%, 5.7%, 5.5%, 1.7% and 0.6% respectively, accounting for 75.7% of the total foreign investment in China during the period (Zhu Wenhui 1996b). In 1996, half of FDI in China came from Hong Kong (49.56%), followed by Japan (8.82%), Taiwan (8.33%) and USA (8.25%). The growth of FDI accompanied or induced continuous increase of trade between China and other East Asian economies. In addition, Japan also provided China with a large amount of government loans to support her economic development.

Third, along with the development of commodity trade, many advanced and appropriate technologies have also been introduced into China. Of those foreign-funded industrial projects in operation, more than 80% have introduced foreign advanced technology, with one-third of that introduced technology being the latest level in the world (Shun Jiaheng 1994).

In introducing foreign technology into China, some East Asian economies have played very important roles. Japan as a developed country has become a major exporter of technology to China. In 1995, for example, Japan was China's second largest source of technological equipment imports. Although not all equipment and technology from Japan were, and were not necessary to be, the most advanced, they have become the means for improving China's industrial capacity. Hong Kong, Singapore and some other East Asian economies, although they are not the origins of advanced technology, have bridged a lot of technology transfers between China and the developed world. The Chinese government has noted the function of foreign investment and technology in China's economic development and will keep its markets open to foreign capital and technology. Undoubtedly this policy will provide many opportunities for foreign investors, especially for those from East Asian economies, to access to the huge China market.

Finally, large amount of raw materials from East Asian economies have also positively supported China's fast economic expansion. Given the facts that near a half of China's trade were processing trade and more than a half of China's trade were intra-regional trade in East Asia, the importance that East Asian economies are as a main resource of productive materials does not need further explanation.

China's economic development over past decades has witnessed the development of a very important dependence on economic relations with East Asian economies, as well as with the developed world. The above description shows the fast development of China's trade with the East Asian economies. However, the statistical evidence above does not demonstrate fully the special significance of the China-East Asian trade. Therefore, I now turn to the following further analysis.

### **7.5.2 The Special Significance of China-East Asia Trade**

The rapid development of China-East Asia economic and trade relations resulted from the mutual benefits between the economies. The East Asian economies are highly complementary. The openness of China's economy through its trade policy reforms generated significant influences on the development of East Asian economies.

First, the growing Chinese markets, and the increasing opening-up of these markets, was one of the positive factors promoting the regional trade growth in East Asia. As a large

developing country, China has abundant natural resources, low-cost labour force and a huge market of 1.2 billion consumers. China's rapid economic growth over the past decades increased domestic demand which enlarged China's market capacity. For industrialisation, China opened its market to the rest of the world. During 1990-1995, the intra-regional trade between Asian economies (including East Asia and other Asian economies) increased from 42.0% of their total exports in 1990 to 50.9% in 1995. In the same period, while Asian intra-regional exports grew with an average annual rate of 16% and the average growth rate of world trade was 12%, exports from other Asian economies to China registered a much higher annual growth rate of 26% (WTO 1996). China's exports to the above mentioned ten other Asian economies also grew with an average annual rate of 15.43% in 1990-1995, although lower than that of its imports from other Asian economies but close to the average growth rate of Asian intra-regional exports. From this data it is evident that China has contributed to the fast growth of Asian intra-regional trade. Of course, as analysed earlier, this increase in China's trade capacity must be attributed to its sustained trade policy reform over the past years.

Second, China's trade policy reform promoted the upgrade of trade structure in Japan and Asian NIEs. Trade policy reforms improved the investment environment in China. By creating some new trade forms, such as compensation trade, China has introduced a large number of labour-intensive plants from Japan and Asian NIEs. It provided a chance for Japan and Asian NIEs to upgrade their technological capacity in order to strengthen their competitiveness in the world markets. By moving some labour-intensive industries to China, and some other South Eastern countries else, Japan and Asian NIEs adjusted their structures of production and trade, and more capital and human resources could be put in technology-intensive industries to improve their comparative advantages. At the same time, the inflows of production factors from Japan and NIEs also accelerated the development of Chinese economy, brought China a large amount of capital and increased employment opportunities for Chinese people. A so-called "flying geese pattern" of development has been successful in Asia.<sup>[2]</sup> Concerning China's performance, export structure has been increasingly enhanced. For example, about a half of China's exports to Japan in 1990 were non-manufactured products, but this proportion dropped to below one-fourth in 1995 (ESCAP 1997, pp.91-92).

Third, the opening of China's market has become a balancing factor in Asian economies, reducing their dependence on developed country markets. Historically, the development of exports in most Asian economies depended highly on the import capacity of developed countries. Although this trend has remained, dependence on developed country markets has been relatively reduced, while the increase of intra-regional trade enabled Asian economies to realise a plural market strategy.

The Asian economies have different features with reference to their resource endowments and market capacities. Japan and Korea have undeniable advantages in advance technology, while other economies have stayed at a relatively low level of technology. Japan and the "Four Little Tigers", after the rapid development of the past decades, have been important capital suppliers in and out of the region, while other countries are still experiencing capital shortage. While the cost of labour in Japan and the "Four Little Tigers" became expensive due to improved living standards, China and other Asian countries continue to benefit from the advantage of low labour costs. The regional market, given the fast growth in this region, has been greatly expanded. China's opening-up and participation has undoubtedly been a positive force in promoting the development of regional trade linkages in Asia. At present, it is safe to say that, parallel to the global division of labour in which Asian economies have been involved through various forms, a regional system of the division of labour has also been formed in Asia.

Fourth, China is becoming a strong competitive force in the world markets. This has in the first place generated significant impacts on its neighbour areas. China's trade policy reform, especially the export promotion policies, strengthened the competition between Asian exporters. Although many differences exist in Asian developing economies, there are also a lot of similarities among them. The fact that many of them are in similar stage of development generated many overlaps between these economies. For example, labour-intensive industries account for a considerable proportion of these economies except Japan. All economies have a strong emphasis on an export-led strategy. Most exports from these economies are concentrated on the markets of developed countries. Therefore, the existing labour-intensive industries in some Asian economies could be affected by China's rising market share.

On the other hand, however, it is worthy of note that the shares of manufactures from East Asia economies to developed countries greatly increased in the 1980s and the early 1990s. Lloyd and Toguchi (1996) pointed out a notable phenomenon that all East Asian economies had successfully increased their market shares in developed countries. In 1980, only 1.15% of developed country markets were supplied from East Asia. By 1993, the percentage increased to 3.74, accounting for 15% of total imports of manufactures from all foreign countries into these markets. This means that China's growth of exports might not be considered as a severe threat to other East Asian exporters. China's exports did, however, grow at a double-digit rate of growth over the post-reform years, becoming the single largest supplier of Asian developing economies in developed country markets. China's participation in export competition will stimulate other East Asian economies to improve their competitiveness. With some necessary trade policy adjustments and the increasingly strengthened economic and trade co-operation, East Asia should maintain its highest rate of economic and trade growth over the longer term.

Finally, China's trade policy reform has benefited from the rapid growth of Asian economy and trade. On the one hand, the expanding Asian economies absorbed a large part of China's exports and supplied lots of materials for China's imports. The fast development of China-East Asia trade provided impetus for China to speed up its trade policy reform and has also helped in maintaining China's rapid growth of foreign trade which has alleviated the shock of trade policy changes. In addition, the trade reform experience of some Asian economies, such as Japan, Korea and Taiwan, has enlightened China's reform approach. As mentioned earlier, East Asia's approach of trade policy reform is different from that of many other countries, typically with heavier government intervention. China has actually been in favour of this pattern of trade policy reform. This pattern should not be considered a extremely bad thing in a transition process from the previously central planning economy, given that reform would move to free trade or liberalisation. China has followed such a way to reform its trade policies and, after a period adjustment, turned to intensive reform in the 1990s. The past two decades of reform have now proven successful in many aspects. Of course, it is arguable whether China should adopt a "big bang" approach to reform. The answer to this is eventually political and thus be beyond the scope of this study. What is certain is that, in Asian tradition, a gradual change in a steady socio-economic environment has always been preferred. In this sense, China's adoption of the East Asian approach of

reform has been understandable and acceptable, for Chinese people and people in other Asian economies.

## 7.6 CONCLUSION

To sum up, China's reforms of its domestic economy and foreign trade policy have generated significant impacts on its trading partners and the world economy as a whole. The changes in China's trade regime and trade policies have induced a series of policy adjustments in the rest of the world. Simultaneously, demands and pressures from trading partners have also had important influences on China's economic and trade policy reforms. An important lesson from China's trade policy reform experience, particularly from the development of China-US trade relationships, is that China should have a well-designed blueprint for its trade policy reform in order to escape from being forced into a passive position. In the next stage of trade policy reform, it will be necessary to give sufficient consideration to changes in the world trade system. The basic trend in China's future trade policy reform should be to liberalise its trade regime and the whole economy further in accordance with international norms.

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<sup>[1]</sup> China's GNP per capita (PPP estimate) in 1996 was US\$3,330, ranking 88th in the world (World Bank 1998, p. 17).

<sup>[2]</sup> For a brief explanation regarding the significance of the "flying geese pattern" for China, see Fukasaku and Wall (1994), p. 71.

## **8 Conclusion and Perspectives on China's Trade Policy Reform**

### **8.1 The Aggregate Evaluation of China's Trade Policy Reform**

#### **8.1.1 The Basic Characteristics of China's Trade Policy Reform**

Almost two decades have passed since the beginning of China's trade reform. In the course of reform, China has made, and will continue to make, a great effort in exploring its own way toward trade liberalisation. While the international experience of trade policy reform has certainly provided significant encouraging for China's reform, much of China's attention has also been focused on the adoption of effective measures to meet the demands of the gradual opening-up of the economy. It is just because of such an effort that China's experience has become a noteworthy case.

First, because China's institutional setting was initially formed to fit the planned economy, trade policy reform inevitably regarded institutional reform as a first step. Only if the institutional structure has been made compatible with the market economy, can trade policy reform be effectively liberalised. That is why China's trade reform was begun with a phase of decentralisation of the trade regime.

Second, in the early stage of China's trade reform, there was no clear plan concerning the target and corresponding measures of reform. This is very different from those trade reform programmes sponsored by international organisations. The model of China's trade reform was adjusted throughout the 1980s and finally confirmed as trade liberalisation based on a market economy in the early 1990s. This suggests that China's trade reform experienced a relatively long "trial-and-error" process in the 1980s. The significant trade policy reform began only as late as the 1990s with a series of intensive trade liberalisation measures.

Third, unlike many other developing countries that launched trade policy reform in response to a heavy debt crisis, the initiative for China's trade reform was to modify the existing centralised economic system. China's trade reform at the beginning appeared as a unilateral effort to participate in the world economy. A turning point was China's

application in 1986 to rejoin the GATT. After that time, external factors began to have an increasing impact on China's trade reform. The increasing influence of external factors was relative to China's growing position in the world economy. Consequently, some countries have placed increasing pressure through multilateral or bilateral trade talks on China to reform its trade regime and trade policy, while China itself has also unilaterally speeded up its reform process.

Fourth, China's trade policy reform was conducted under different ideological perspectives and economic conditions from those found in many other developing countries. The aim of China's economic reform was never capitalism, nor the previous socialism that existed in China in the past. Trade policy reforms in China cannot be explained within the context of traditional concepts of capitalism and socialism, or a simple mixture of the two. Very probably, the Chinese leaders intend to create a new type of economic system and foreign trade regime.

Finally, the Chinese government tried hard to control the reform path. The Chinese special economic and political situation also enabled China to adopt the path of least resistance or gradual reform in its economic system and foreign trade. On the domestic side, efforts were made to maintain social and economic stability, in order to provide a stable socio-economic environment to carry on trade policy reforms as well as the reform of the whole economy. Although this attempt, and corresponding measures, sometimes retarded a speedy reform, the risk of a sharp shock to the economic transition process has been successfully avoided.

Some of the above features may be shared by other reforming countries. However, the combination of all these features enabled China's trade policy reform to be unique. In other words, China's trade policy reform has been a particular case of trade liberalisation. This uniqueness is reflected in that China's trade policy reform has produced undeniably positive results which direct China towards trade liberalisation, while maintaining its ideological requirement and relatively strong government intervention. Given the achievements and the special nature of trade policy reform, China's experience may represent a different path for trade liberalisation in transitional economies.



### 8.1.2 Assessing China's Experience of Trade Policy Reform

As already mentioned, trade policy reform involves various factors. Among them, the main ones concern the choice of trade strategy, the establishment of a market mechanism system, institutional reorganisation and the implementations of trade policy measures. What has China achieved of these aspects of trade policy reform? What are the significance of these policy changes? What are, if any, the lessons that can be drawn from China's experience of trade policy reform?

#### *Foreign Trade Strategy*

For a less-developed country, the path of development is always a central problem of policy-making. Various trade strategy models, either inward-looking or outward-looking economy versions, are only workable at certain stages in a country's development. The assessment of the role of foreign trade in development will strongly influence a country's policy choice. However, it is notable that, as the importance of trade and the conditions for policy implementation are changeable, trade strategy will be adjusted to match the changing objectives. In this sense, trade policy reform result from the shift of trade strategy.

In the present world, international economic linkage requires countries to adopt a more open strategy for utilising external resources to support domestic growth. A number of countries (areas) have successfully demonstrated the great significance of shifting trade strategy away from the state of isolation. Given the advantages of open trade, the emergence of trade strategy shifts and trade policy reforms were seen in developing countries in recent decades. China, like many reforming countries, also experienced a trade strategy shift from a closed, inward-looking type to an open, outward-looking one.

China's adoption of the open-door policy signalled the change of foreign trade strategy. China has made a great effort to develop its external economic linkages and expand its exports. Since 1978, China has been experiencing a change from a "strongly inward-looking" to a "moderately outward-looking" regime (Xue Jingxiao *et al.* 1989). Specifically, as analysed in this study, China's previous overall import substitution strategy has been turned into a basically neutral strategy integrating export promotion with import substitution. During the course of reform, a series of measures were adopted to make China's foreign

trade regime conform to international trade norms. A multi-layer directional pattern of opening-up of trade has been developed in China.

It is important to note that China's trade reform was by no means an across-the-board liberalisation. Analysis in this study has shown that China's present economic and trade structures still have characteristics of import substitution, although the IS strategy has lost its previously dominant position. The debate on trade strategy among Chinese economists and policy-makers in the reform period led to a reconsideration of the choice of an appropriate approach to industrialisation. For China, it would be impracticable to eliminate import substitution totally at the present stage of economic development. This is by no means suggesting that China prefers the protectionist policy of the IS strategy. Any choice of trade strategy should fit the initial conditions in the transforming country to ensure the best effect of strategy change. China is a big country in which there is a relatively complete structure of industries on the supply side and a huge consumption requirement on the demand side as well. The domestic circulation is the main aspect of development. Developing the ingredients of an outward-looking economy is only one way through which China can optimise and accelerate its economic development.

However, it is equally important that trade plays a significant role in the process of industrialisation. Protectionist policies are frowned on within the international community. Given the changes of its internal and external environment, the development of foreign trade may be a key for the transition of the economic structure. The experience of Japan, Korea and some other successful NIEs showed that outward development is a necessary stage in the course of industrialisation. A late-comer country can make good use of the functions of trade to transfer foreign advanced production forces into its own economy, improve its abilities on technology development and export expansion, promote and upgrade domestic economic structure, and realise industrialisation. This suggests that China needs more open policies to stimulate foreign trade in order to obtain stronger stimulus for industrialisation.

It is possible to conclude that a mixed trade strategy combining export promotion and import substitution ingredients has been the right choice for China at present stage of development. The shift of trade strategy from import substitution to export promotion has

given trade a more important role to play. It was the shift in trade strategy that has led China on the road of development with greater dependence on trade. More importantly, the change of trade strategy has motivated China to build an open regime and to integrate itself within the world economy.

### ***The Domestic Economy and Foreign Trade***

In the course of economic and trade reform, the domestic economy has two roles. On the one hand, the domestic economy determines the initial conditions for trade reform. On the other, the domestic economy reflects the effects of trade reform. In the latter, trade reform acts as a factor inducing the reforms in the domestic economy. Ideally, trade policy reform is expected to make full use of the interactions between trade reform and the domestic reforms to promote development on the both sides. However, in China's experience, the relationships between trade reform and the domestic reforms have witnessed very different situations.

From the view of the domestic economy as a precondition and support to trade policy reform, China's experience has not been advantageous due to the relatively slow transition of the economy from plan to market. The success of trade policy reform requires supports from other sectors. Any lag in the relevant policy adjustment may delay the pace of trade policy reform. China has a relatively long history of a planned economy in which the market mechanism was severely restrained. The reforms since the end of 1978 have involved the expansion of enterprise autonomy and the introduction of the market mechanism. But the progress in establishing a market system seemed behind the demand of trade policy reform. Moreover, the reform timing has not been clear for a quite long time. The beginning of trade reform was much behind the reforms in other sectors. Many crucial domestic reforms including foreign exchange regime reform, price reform and taxation reform have not been in place until recent years. To obtain an appropriate environment, trade policy reform has had to be delayed. The long-lasting dual exchange rate system and the rarity of tariff reductions in the 1980s, were due a great extent to the stagnated reforms in some related domestic sectors.

Regarding the effect of trade policy reform on the domestic reforms, as analysed in this study, trade policy reform has in fact triggered a series of domestic reforms. Because of the

openness of trade, the domestic market encountered increasing competition which shook the previous closed-type regime. The most important contribution of trade reform to China's economic development was that trade has been an effective channel in which a lot of advanced technology and managerial knowledge were introduced into the economy. By reforming the trade regime and trade policies, the prices, fiscal, taxation, finance, exchange rate, customs systems and enterprises all had to change to match the trade liberalisation strategy. Through reform, many international norms have been applied in these fields. Even the adoption of the dual exchange rates, the foreign exchange retention system, the subsidy policies were all to compensate for the weakness of the IS strategy bias. In turn, with the progress in the marketisation of the domestic economy, trade policies were gradually normalised in the course of reform. As analysed in the preceding chapters, trade has been an important source of China's rapid economic growth.

In balance, a conclusion which can be reached here is that the gradual reforms in China's domestic economy have provided a solid ground for the success of trade policy reform. However, the relatively slow pace of the domestic reforms resulting from the gradualism have obstructed a fast deepening of trade policy reform. By contrast, trade policy reform has been a positive driving force inducing a number of the domestic reforms. Trade policy reform, in this sense, has become the crucial touchstone of China's market reforms.

### ***The Role of Government***

The role of government in economic development has become a popular subject in recent decades. More than a few economists have argued that governments have to play an important role in the development process (and in economic transition), whether their perception of the government's role was in the broad or in the narrow range. At least, appropriate economic policies and effective government administration may lead in the direction of development/transition. It is, then, not surprising that trade reform will be significantly influenced by governmental policy guidance.

As discussed, the role of government seemed more important in China's trade reform. China has been transforming its economy from a centrally planned economy to a market economy. The importance of the central plan has declined considerably as the process of decentralisation has progressed. However, it is important to note that the appropriate role of

government has not yet been defined. China's market economy is still under construction. The market mechanism is far from complete so that the "market" cannot provide complete signals for enterprises. Economic adjustments have to rely partly on administrative measures. Most importantly, China's political conditions and the ideological perspective still demand that the government keeps control of economic and trade reforms.

Now the question remains as to why China's trade policy reform with strong government intervention has been effective? Is it because the role of government has been well-defined? The answer to the second question is certainly not. As shown in the analysis in the preceding chapters, China's trade policy reform has featured excessive government intervention and many of these interventions were administrative and operating against market forces. On the other hand, however, it was by administrative intervention that China has introduced market forces into the economy to give a more important role to trade policy. The fact that the government commits itself to a dual role, regulating foreign trade on the one hand and liberalising trade policy on the other, reflects the very special nature of China's transitional economy. A very important factor contributing to the success of reform was a balanced use of administrative intervention and market forces, aimed at a gradual transition of the economy. The art of reform, increasing the function and scope of market mechanisms while reducing the range of government control, has kept producing a increasingly better policy environment to stimulate trade growth. In this way, trade policies have been reformed one after another. Looking at the whole course of reform, trade policy has gradually moved towards liberalisation. In this sense, the government has played an important role in promoting trade liberalisation in China.

In sum, the old system has not been totally denounced in China. Reform means change. But the direction of change in China is by no means toward a capitalist system. In other words, since the beginning of reform, China has been exploring a new way to combine socialist ideology with market mechanisms. For the reasons mentioned above, it is not surprising that China will maintain the role of government in guiding its trade reform. The predictable change seems only in the form of intervention, moving from direct intervention to a more indirect one.

### *Changes of Trade Policy*

As with other economic reforms, there are two paths along which the trade policy reform can be carried out. One is the “big bang” and the other is gradualism. The experience of different countries reflect these different models. Chile’s trade reform represents the case of an across-the-board liberalisation in shock therapy mode. In Russia, the big bang approach was adopted for the aggregate economy except for foreign trade. Trade reform in Russia was much slower than the reforms in other sectors. Japan and Korea, and China too, have conducted their trade reforms following the path of gradualism.

China is a typical example of gradual trade reform in the contemporary world. However China’s reform process also had different paces in the past reform years. Reform seemed to lag behind the overall economic reform in the 1980s but has been accelerated in the 1990s. In the 1980s, China’s trade policy was concentrating on the creation of export incentives. Some strong promotion measures including export subsidies, foreign exchange retention and duty drawback were alternatively used to stimulate export growth while imports were still strictly controlled. Planning control over trade decreased along with an increase of some quantitative restraints, such as the application of an import licensing system. In the 1990s, the emphasis of reform has turned to trade policies. Reforms include the abolition of export subsidies, the reduction and elimination of mandatory trade plans, the reductions of tariffs, the unification of foreign exchange rates, the phase-out of the exchange retention system, the rationalisation of the licensing system, and the adjustment of trade-related taxation and foreign investment policies.

It is worth noting that the real trade liberalisation, particularly import liberalisation, was able to be started much later than reforms on export side, as occurred in Japan and Korea in the past decades. In addition, a similar feature of trade policy reform shared by Japan, Korea and China is that trade liberalisation was started under heavy international pressure, although the domestic economic situation was also a determinant of liberalisation. China has tried to follow the Japanese and Korean models to reform its trade regime and trade policies gradually. However, the changing international environment has altered China’s expectation. Linked to its desire to participate in the international economy and to join the GATT/WTO, China, unlike Japan and Korea, has had to accelerate its process of liberalisation before the completion of industrialisation. This suggests that the Japanese (or

Korean) model of industrialisation may only have been a historical success story. China could not simply follow this model in the reform of its trade regime and trade policies.

The main conclusion therefore is that: China's trade policy reform has been proven to be effective and has moved in the right direction towards liberalisation. First, as shown by the statistics and the econometric analysis in this study, China's trade policy reform has generated a positive contribution to economic growth. The domestic reforms have also benefited from the sustained trade policy reform. Through the efforts of trade liberalisation, China's economy has become more open than it was. Second, China began its trade policy reform as a trial based on gradualism but this has been turned into a fast overall reform in the 1990s, in contrast to the relatively long adjustment period after the big-bang transition in Russia. Regardless of the preference for the gradual approach, the pace of China's trade policy reform reflected the underlying factor for a successful reform to fit the special conditions in the reforming country and to adapt the reforms to the changing environment of the world economy. Third, China changed its reform emphasis from one compensating for the policy distortions under the IS strategy, by creating various export incentives in the 1980s, to one establishing a neutral trade regime in the 1990s. This move with significant reductions of export incentives and import barriers has been in the direction of trade liberalisation. China's increasingly open trade policy regime with a commitment toward liberalisation has provided a solid basis on which to integrate herself into the world economy. Finally, it is worth noting that there were many difficulties in the course of China's trade policy reform. The issue of China's unsettled status in the GATT/WTO implies that the external factors will have significant influence on a country's reform process on the one hand, but also indicates that there is still much to be done with China's economic and trade reform on the other.

## **8.2 The Challenge Facing China**

China's insistence on an open-door policy has been the motor for reform in the trade system and trade policies. The reforms of the foreign trade system and trade policies have brought great changes to China's economic development. China is now a major player in the world economy. In recent years, China has faced a new challenge: How to more fully bring China into the role of major foreign trader (Reporter of *China's Foreign Trade* 1993). The

target for the year 2000 has set total import and export volumes to surpass US\$400 billion, with each surpassing US\$200 billion (Xiao Qiang 1995).

To achieve this goal, China must actively participate in global trade and develop multilateral trade and economic relations. If China wants to accelerate its economic development by taking advantage of internationally oriented strategies, it has to deepen its foreign trade reform and widen its open door policy continuously.

### **8.2.1 Free Trade versus Chinese Characteristics**

No matter what kind of economic pattern is preferred, the effective way to participate in international trade deeply is to formalise foreign trade policies in accordance with common international practice. Liberalising trade policy is necessary to further China's reform and opening up process.

Since the late 1970s, China has been continuously emphasising the open-door policy although the pace was small and slow at the beginning. Each step implemented, including the granting of trading rights to enterprises, the establishment of SEZs, the introduction of foreign capital, and various measures to improve trade conditions, reflected the attempt to open the economy to the outside world and reform the foreign trade system. In particular, trade policy reform in China since the 1990s, such as the readjustment of some abnormal trade policies, the implementation of the unified policies of foreign trade and economic co-operation, and the enhancement of the transparency of trade policies, were evidence that China has been moving closer to international norms.

For China, however, the biggest challenge is to find a way to integrate its "socialist economy" with an international economic system which is based on capitalism, by means of its so-called "socialist free trade system". This leads a further discussion back to the essential and debatable question of reform approaches presented at the beginning of this study. Analysis in this study showed that China has followed a trade policy reform approach different from that of neo-classical free trade theory, but has achieved great progress in trade liberalisation.



China's major achievements in the reform and opening-up period were highly correlated with the liberalisation of economic policies, including trade policy. While the target of Chinese economic reform has been set up as a "socialist market economy", the trend of trade liberalisation has gradually become clearer. The pace of liberalisation has also been speeded up. Predictably, the trend of trade liberalisation in China seems irreversible because of the external environment of trade reform and domestic economic development. While the fruits of reform are being enjoyed, further reform should be considered as well. The key factor for the acceleration of liberalisation is that the economy should be an open market economy in which liberal economic policy prevails. Wu Yi, the last minister of MOTFEC, proclaimed that China will open its domestic markets to all trade partners and is against all trade protectionism (Jiang Min 1994). The Chinese government has called for the establishment of a free trade system in China. In its *Foreign Trade Law* (1994), China announced that it will maintain a "fair and free foreign trade system". In this sense, the direction of China's trade reform is to establish a "socialist free trade system" (Gu Yongjiang 1996; Li Siyu 1996).

China's "socialist free trade system" has a two-fold task to complete. On the one hand, China's trade system is required to comply with the customary rules of international trade practice. To develop China's foreign trade and to integrate China's economy with the world economy, China needs to establish a trade regime that is compatible with the international trading system. Basically, an open, efficient market mechanism should be the foundation of such an outward-oriented trade system. Although the trade systems of developing and developed countries vary greatly, there is a common foundation of a market economic system and its operation mechanisms on which the customary rules of international trade have been formed. This means the Chinese trade system must also be based on the operating mechanisms of market economies and that trade policies will basically have a neutral pattern. As many Chinese realised, if China wants to integrate with the world economy, the only way is to develop a market economy to replace the old system under the monopoly of the State (Li Siyu 1996; Xu Yu and Ma Lijun 1996).

On the other hand, as a part of the national economy, China's foreign trade system has to have Chinese socialist characteristics, as claimed by the Chinese government. More specifically, public ownership and trade planning guidance will be major features of the

new trade system, under the terms of the socialist market economy. China has clearly stated that it “will never go in for privatisation”, since public ownership plays a dominant role in the socialist market economy (Li Lanqing 1996). China’s stance regarding privatisation is that “privatisation would not necessarily help to perfect the country’s market economic system” (Li Zhongzhou 1996). In the foreign trade sector, the real situation is that almost all units with trading rights, apart from foreign-funded enterprises, are state-owned FTCs and state-owned industrial enterprises (The Project Research Team of Peking University 1996). In other words, public ownership has been the dominant ingredient of property ownership in the foreign trade sector, while the private economy has been developed to a relatively large scale in other sectors. Although in 1997 a few Sino-foreign jointly-funded foreign trade corporations were approved to be set up,<sup>[1]</sup> this situation is unlikely to be fundamentally changed in the near future because that the Chinese government is firmly holding the stance of maintaining the dominant role of public ownership.

### **8.2.2 The Connecting Point**

It is necessary to appreciate the nature of the Chinese “socialist market economy”. One definition is as follows: “A socialist market economy means the establishment of such an economic system in which public ownership integrates with the market economy internally, the market mechanism plays a fundamental role in the development of resources under the positive and effective macro-adjustment by the state, and efficiency and equitableness are fulfilled at a high level” (Gao Shangquan 1993).<sup>[2]</sup> A concise explanation is that the system incorporates (1) public ownership, (2) rational distribution according to one’s contribution, and (3) macromanagement through state planning (Liu Rixin 1994).<sup>[3]</sup> In a wider view, the so-called “socialist market economy” describes the market economy having (1) the foundation of public ownership of property, (2) the aim of common prosperity, (3) the compatible guidance of flexible plans, (4) transparency and no corruption, (5) peasants as the majority of participants, (6) labouring people as master, (7) active state-owned enterprises, and (8) relatively low productivity in the primary stage of socialism (Yang Shengming 1996).<sup>[4]</sup> Among these characteristics, most are related to socialist ideology. Concerning the market operation mechanisms, the key points are the type of property rights and the role of plans (or the state). China’s insistence on non-privatisation and the planning guidance will make its market economy different from those of other countries.

Considering the need to place such characteristics in China's future trade regime, it is worth thinking about the way in which China can realise its so-called socialist free trade system. These characteristics require China to choose a different way towards trade liberalisation. International society's worries about the nature of China's trade liberalisation is simply concern about its insistence on public ownership and trade planning management. In the existing economic theory, there is no full explanation of this kind of trade reform. In practice, China's concept is unique. However, Chinese experience over the past years of reform of following just such a "unique" route to reform has achieved undeniable success. The realistic attitude in promoting China's trade reform perhaps is to explore the way to harmonise the goals of Chinese characteristics and trade liberalisation.

The crucial difference, and the connecting point as well, between China's socialist free trade system and that existing in the world economy is the view on the role of government. Public ownership is to be the foundation of government controls over trade and the economy. In many Chinese leaders and economists' view, government needs to play an important role in the process of trade policy reform and economic transition. However, the real risk behind the China's experience in the past reform period is that trade policy reform has been obstructed by excessive government intervention based on administrative forces. If such a situation cannot be changed, further trade policy reform will be less significant, because enterprises that are assumed to be major entities in the market economy cannot act fully independently in response to market signals.

Theoretically, states (governments) can be classified according to with their interventionist tendencies. The "minimalist state" tends to be a liberal non-interventionist state; intervening in the economy only in case of market failure. Otherwise, economic activities are independent from government regulations. Traditional capitalist countries are, by and large, of this kind. The "maximalist state" is one in which the state's political power in the economy is reinforced by state ownership of the means of production. Most socialist countries before the end of the Cold War belonged to this category. The third kind of state is neither the minimalist nor the maximalist, but falls loosely between these two extreme. This state goes beyond correcting market failure or simply setting the rules of the game; meanwhile, it does not allow complete control of the economy through political authority. Japan and East Asian NIEs basically fit into this form of state (Lee, K. 1993, p. 13).

Trade policy liberalisation in China has actually been led by governmental guidance. Regarding the role of planning guidance over foreign trade, China argued that it will make the Chinese trade regime different from those of other countries. Referring to the experience of East Asian economies, an effective combination of market and government forces may create a more favourable environment for trade reform. China's market operation mechanism seems to be one closer to that of Japan and some other East Asian economies (The Project Research Team of UIBE 1995). This alternative reflects the need for planning guidance in a socialist market economy and the preference of Chinese people for management planning. Most Chinese leaders and economists have however realised that administrative controls over foreign trade need to be transferred to a market-based indirect control system. Superficially, China has phased out mandatory trade plans since 1994. However, due partly to imperfect new indirect macro-control over foreign trade and partly to the inertia of the old trade management system, trade planning has still been playing a major role in foreign trade. In addition, as pointed out in Chapter 2, most trade enterprises have not been converted into truly independent market entities due to the incompleteness of a full-functioning market system in China. With the administrative interventions through the remaining linkages between trade enterprises and their administrative authorities, it is not surprising that guidance trade plans have effects like that of the previous mandatory plans.

How can China continue its trade liberalisation while allowing necessary government intervention? A common policy recommendation for China's reform is that China needs to reduce government intervention over economic activities in line with the principle of a minimalist state, as in the cases of many western countries. Since a trend towards a minimalist state is regarded as an essential precondition for the establishment of a market economy, China has greatly reduced government supervision over economic operation during its reform and opening process. However, the minimalist state is not the goal of China's economic and trade reforms. The problem is not how to choose a maximal state or a minimal state because these two extreme forms of state are not found in practice in the real world. Most states in the world are mixed. The difference between various mixed states is the different degrees of intervention in their economies. It is important to realise that the change in the government's role may generate either positive or negative effects for

economic development. Every adoption or elimination of an economic policy implies a changing role for the government. From this standpoint, the changing role of the Chinese government during the reform period has provided strong stimulation to push the reform and opening forward. The reduction of government intervention has become the precondition of trade policy liberalisation in China. Thus, without the relaxation of government controls, any trade policy liberalisation is unimaginable in China, especially considering of the high level of control over the economy before the reform and opening policies were adopted.

To deal with the relations between the state and the market, the key problem is to seek an optimum combination of these two factors. In East Asian cases, and to a lesser extent the developed countries as well, a workable model is to make appropriate use of government intervention on the base of a market economy. All government interventions are carried out as compatible with, or at least as not severely destroying, market principles and through the use of economic instruments (not in the form of administrative command). This is an extremely important experience which should be considered an enlightenment for China, given that relatively strong government intervention is likely to remain present in China's future trade policy reform.

At the current stage of trade policy reform, China really needs to adopt a "market first" reform strategy. The lack of a complete market system has been a "dead-weight" weakness in China's economic and trade reform. Distinguished from the reform strategy adopted in China for the whole reform period so far, by which only some selected market mechanisms were transplanted into the administrative-force-based economic and trade systems, the "market first" strategy would ensure that market mechanisms would be the real forces in economic operation. Even allowing for the continued necessity of some government interventions, it is necessary to complete the establishment of the market systems first. If necessary and appropriate, government intervention can be developed on a market basis, through the effective use of market levers and with the least damage to the market system. Only with the foundation of an efficient market mechanism can trade policy reform ensure a move toward liberalisation and appropriate government guidance be effective. In other words, trade liberalisation and government guidance can only be effectively combined in a market economy.

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<sup>[1]</sup> In July 1997, China for the first time approved two Sino-Foreign jointly-funded trade corporations to be set up (*China Economic Times* 3/9/1997). It was reported the number of such Sino-Foreign jointly-funded trade corporations was four in Shanghai by the late 1997 (Yao Sufeng 1997). This measure represented that the foreign trade sector, which has been remained state-owned for the past reform years, has also been opened to foreign investors.

<sup>[2]</sup> Gao Shangquan was formerly Vice-Minister of the State Economic Reform Commission.

<sup>[3]</sup> Liu Rixin is research fellow of the Macroeconomic Research Institute of the State Planning Commission.

<sup>[4]</sup> Yang Shengmin is Director of the Institute of Trade and Finance, the Chinese Academy of Social Science.

## Appendix

Table 1: Exchange Rates and Trade Bias Ratio

	OER	AER	EER <sub>x</sub>	EER <sub>M</sub>	EER <sub>M</sub> /EER <sub>x</sub>	REER	ADCOFE
1976	1.94	1.94				1.9445	
1977	1.86	1.86				1.9351	
1978	1.68	1.68				1.8629	
1979	1.56	1.56	1.56	1.73	1.1064	1.8897	2.40
1980	1.50	1.50	1.94	2.16	1.1116	2.4861	2.31
1981	1.71	2.88	2.88	3.29	1.1434	3.9671	2.48
1982	1.89	2.88	2.88	3.25	1.1303	4.1304	2.67
1983	1.98	2.88	2.88	3.24	1.1273	4.1778	3.07
1984	2.32	2.88	2.88	3.35	1.1621	4.2455	2.80
1985	2.94	3.24	3.24	3.77	1.1652	4.4231	3.24
1986	3.45	3.66	4.02	4.03	1.0041	4.7535	4.00
1987	3.72	4.46	4.58	4.56	0.9971	5.5318	4.13
1988	3.72	5.08	4.90	4.93	1.0048	5.4163	4.41
1989	3.77	4.92	4.79	4.87	1.0165	4.7338	4.85
1990	4.78	5.18	5.24	5.35	1.0210	5.1848	5.19
1991	5.32	5.74	5.56	5.77	1.0381	5.2744	6.00
1992	5.51	7.40	6.20	6.47	1.0436	5.1865	7.09
1993	5.76	8.11	6.60	6.87	1.0409	4.7720	7.60
1994	8.62	8.62	8.62	8.86	1.0274	6.2461	8.65
1995	8.39	8.39	8.39	8.61	1.0263	5.3370	8.30
1996	8.31	8.31	8.31	8.53	1.0262	5.0211	8.43
1997	8.28	8.28				5.0269	

Note: OER denotes official exchange rate, AER the applied exchange rate, EER<sub>x</sub> the effective exchange rate on exports, EER<sub>M</sub> the effective exchange rate on imports, and REER the real effective exchange rate. ADCOFE is the average domestic cost of foreign exchange (Chukou Huanhui Pingjun Chengben), which can be considered an alternative approximate EER<sub>x</sub> according to their definitions. As can be seen in the table, the constructed EER<sub>x</sub> are quite close to the ADCOFE.

Source: OER are from *China Statistical Yearbook* (various issues) and *International Financial Statistics* (various issues).

ADCOFE are compiled by the author based on various sources as follows: Figure for 1979 is from Chen Biao (1992, p. 18); data for 1980-1984 are from Wang Zhengzhong (1986); figure for 1985 is from Sung Yun-Wing (1992), considering Guangdong's figure as nationwide level; figure for 1986 is from Yuan Gangming (1987); data for 1987-1990 are from Qiang Yongchang (1993), taking Shanghai's data as nationwide levels; figure for 1991 is from Tang Haiyan (1991), with considering Nanjing's level as reference (Zhu Tonghua *et al.* 1991); figure for 1993 is from Wang Zixian (1994); data for 1994-1995 are from Huang Xianhai (1996); figure for 1996 is estimated based on Qiu Ren and Wang Zhenzhi (1997).

Other exchange rates are constructed by the author. The method of data construction is described in Chapter 6.

Table 2: Indices of China's RCA and Trade Performance

SITC Code	Description	China's Exports		China's Imports		World Exports		RCA		NX Index	
		1990	1995	1990	1995	1990	1995	1990	1995	1990	1995
0-4 (+68)	Primary exports	16.483	23.417	10.432	24.737	913.287	1114.216	<b>0.99</b>	<b>0.70</b>	0.22	-0.03
5-8 (-68)	Manufactured exports	33.983	126.156	33.923	106.648	2422.023	3737.989	<b>0.77</b>	<b>1.12</b>	0.001	0.08
0 and 1	Food, beverages & tobacco	6.951	11.323	3.492	6.525	296.463	408.916	1.29	0.92	0.33	0.27
2	Crude materials, inedible, except fuels	3.537	4.375	4.107	10.158	164.396	215.418	1.19	0.68	-0.07	-0.40
3	Lubricants & related materials	5.237	5.335	1.272	5.127	363.995	359.537	0.79	0.49	0.61	0.02
4	Animal & vegetable oils, fats & waxes	0.161	0.454	0.982	2.601	13.336	25.712	0.67	0.59	-0.72	-0.70
5	Chemicals & related products. nes	3.73	9.904	6.648	17.3	303.531	473.406	0.68	0.70	-0.28	-0.27
7	Machinery & transport equipment	5.588	31.391	16.845	52.638	1208.731	1925.093	0.25	0.54	-0.50	-0.25
6 and 8	Other manufactured articles	25.262	86.791	11.009	37.036	984.858	1444.123	1.41	2.00	0.39	0.40
9	Products not classified elsewhere	11.625	0.007	8.99	0.693	86.703	132.844	7.39	0.00	0.13	-0.98
22	Oil seeds, oleaginous fruit	0.619	0.522			10.621	12.685	3.21	1.37		
26	Textile fibres	1.096	0.753	1.839	3.818	24.52	33.387	2.46	0.75	-0.25	-0.67
27	Crude fertilizers & minerals	0.516	0.979			12.688	14.182	2.24	2.30		
28	Metalliferous ores & metal scrap	0.211	0.163	0.95		37.309	48.67	0.31	0.11	-0.64	
65	Textile yarn & fabrics	7.219	13.918	5.426	11.177	111.047	161.213	3.58	2.88	0.14	0.11
67	Iron & steel	1.283	5.161	2.776	6.979	110.409	156.721	0.64	1.10	-0.37	-0.15
68	Non-ferrous metals	0.597	1.93	0.579		75.097	104.633	0.44	0.61	0.02	
84	Clothing & accessories	9.669	24.049	0.048	0.959	110.808	162.476	4.81	4.93	0.99	0.92
001	Live animals for food	0.429	0.473	0.014	0.018	8.599	9.907	2.75	1.59	0.94	0.93
041-045	Cereals	0.54	0.076	2.32	3.58	33.086	37.392	0.90	0.07	-0.62	-0.96
057	Fruit, nuts, fresh, dried	0.259	0.445	0.023	0.084	19.06	27.512	0.75	0.54	0.84	0.68
111	Non-alcoholic beverages nes	0.117	0.229	0.018	0.002	2.338	4.373	2.76	1.75	0.73	0.98
121-122	Tobacco	0.17	0.999	0.13	0.359	17.86	23.502	0.52	1.42	0.13	0.47
251	Pulp & waste paper	0.002	0.029	0.287	0.845	17.704	26.947	0.01	0.04	-0.99	-0.93
261	Silk	0.453	0.353	0.004	0.016	0.742	0.602	33.65	19.54	0.98	0.91
263	Cotton	0.318	0.049	0.718	1.487	9.009	13.68	1.95	0.12	-0.39	-0.94
266	Synthetic fibres to spin	0.007	0.031	0.554	1.316	3.557	5.947	0.11	0.17	-0.98	-0.95
271	Fertilisers, crude	0.012	0.042	0.018	0.01	1.37	1.282	0.48	1.09	-0.20	0.62
333-335	Crude Petroleum & petroleum products	4.472	3.243	1.054	4.613	288.615	272.014	0.85	0.40	0.62	-0.17
541	Medicinal & Pharmaceutical products	0.643	1.582	0.417	0.407	37.753	71.59	0.94	0.74	0.21	0.59
562	Manufactured fertilisers	0.025	0.13	2.603	3.732	13.933	14.789	0.10	0.29	-0.98	-0.93
591	Pesticides	0.068	0.234	0.178	0.16	7.346	10.364	0.51	0.75	-0.45	0.19
635	Wood manufactures nes	0.254	0.849	0.026	0.112	7.45	13.322	1.88	2.12	0.81	0.77
651	Textile yarn	1.008	2.111	0.593	2.461	23.088	32.941	2.41	2.14	0.26	-0.08
652	Cotton fabrics	1.823	3.457	2.989	1.529	15.559	21.01	6.46	5.48	-0.24	0.39
658	Textile articles nes	1.376	2.561	0.058	0.045	8.373	12.673	9.06	6.73	0.92	0.97
673-674	Iron & steel shapes, plate, sheet, etc.	0.498	1.18	1.812	4.537	56.505	78.194	0.49	0.50	-0.57	-0.59
721-722	Agricultural machinery	0.056	0.1	0.115	0.149	16.714	18.862	0.18	0.18	-0.35	-0.20
724	Textile & leather machinery	0.215	0.404	1.204	3.181	21.436	23.763	0.55	0.57	-0.70	-0.77
736	Metalworking machine-tools	0.25	0.335	0.544	2.344	24.201	27.452	0.57	0.41	-0.37	-0.75
751	Office Machines	0.161	0.851	0.115	0.082	11.725	15.595	0.76	1.82	0.17	0.82
752	Automatic data processing equipment	0.097	2.302	0.366	1.051	67.028	123.84	0.08	0.62	-0.58	0.37
761	Television receivers	0.556	0.808	0.14	0.335	16.056	22.633	1.91	1.19	0.60	0.41
821	Furniture & relative parts	0.322	1.765	0.072	0.102	28.282	44.881	0.63	1.31	0.63	0.89
831	Travel goods and handbags	0.385	2.87	0.006	0.042	7.618	14.514	2.79	6.59	0.97	0.97
871	Optical instruments	0.025	0.315	0.019	0.151	3.827	7.731	0.36	1.36	0.14	0.35
872	Medical instruments nes	0.029	0.168	0.05	0.154	10.133	16.519	0.16	0.34	-0.27	0.04
893	Plastic articles nes	0.32	2.566	0.188	0.895	27.274	48.3	0.65	1.77	0.26	0.48
894	Toys, sport goods, etc	1.971	5.862	0.833	0.472	20.721	38.737	5.24	5.04	0.41	0.85

Source: State Statistical Bureau (1996a, 1996b, 1997a, 1997b); MOFTEC (1997); State Planning Committee (1997); United Nations (1993, 1996, 1997).



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